Legal Phases of Farmer Cooperatives

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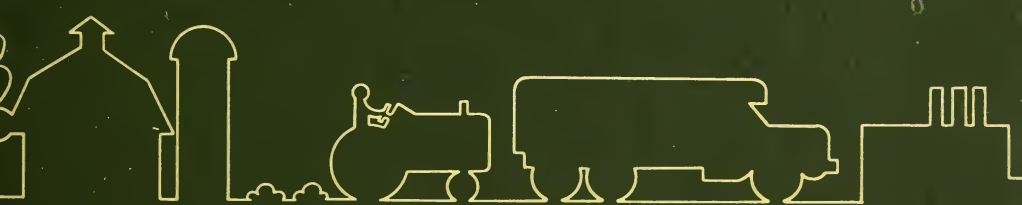
Federal Income Taxes



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Farmer Cooperative Service
U.S. Department of Agriculture

PREFACE

The Department of Agriculture first published a bulletin on cooperatives and the law in October 1922. It was revised extensively in October 1929, May 1942, January 1959, and April 1972. The Department is publishing the 1976 revision of *Legal Phases of Farmer Cooperatives* in parts as well as in one complete publication. The other parts are *Sample Legal Documents* and *Antitrust Laws*.

This part was prepared by Morrison Neely, Office of the General Counsel, before his death in 1974 and updated in December 1975 by James R. Baarda of Farmer Cooperative Service.

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Stock Number 001-017-00034-9

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Revenue rulings during 1974 dealt with several issues of cooperative taxation. Calculation of amounts available for patronage distribution and the problem of income from patronage sources were the two subjects of most of the rulings. Depreciation was the subject of three rulings, and investment credit calculations and equality of treatment for section 521 qualification were subjects of one ruling each. The rulings are here summarized.

Rev. Rul. 74-20, I.R.B. 1974-2, 13, disapproved a nonproportional determination of cooperative income available for patronage treatment. The cooperative had income from both members and nonmembers. The ruling prohibited an artificial adjustment to the members' contributions that would make the proportion of total cooperative income available for patronage distribution larger than the proportion of total income contributed by the members to whom patronage was to be distributed.

Where a State taxed nonmember-derived income of a cooperative but not income derived from members that was distributed to members as patronage dividends, the expense was allocated strictly to nonmember-derived income, and net earnings available for distribution to patrons were not reduced by the amount of the tax. Rev. Rul. 74-161, I.R.B. 1974-14, 15.

Problems arising from the different treatment of member and nonmember business again arose in Rev. Rul. 74-377, I.R.B. 1974-31, 22. The cooperative sustained a net loss from nonmember business but a net gain from business with members that exceeded in amount the loss. Because the loss did not arise from patrons being dealt with on a cooperative basis, the loss was not to be subtracted from the net gain that resulted from operations on a cooperative basis. The gain was fully available for patronage distribution and the loss could be treated as a loss under section

172. The carryback and carryforward could be applied to gains or losses of the cooperative resulting from business not done on a cooperative basis.

The question of patronage income arose in a rather interesting manner in Rev. Rul. 74-24, I.R.B. 1974-2, 14. Section 631 (a) permits the cutting of timber to be treated as a sale or exchange of the timber. The timber was cut by the cooperative members and some nonmembers through the cooperative. The question was whether the income realized was income from patronage sources. The ruling held that, to the extent the cooperative income was attributable to the efforts of members, the income was income from patronage sources available for distribution on a cooperative basis.

In a sale of capital property described in section 1231, the cooperative in Rev. Rul. 74-84, I.R.B. 1974-7, 15, also had section 1245 ordinary income. It was held that the section 1245 recaptured income was income from patronage sources available for patronage distribution. The cooperative was merely recapturing income that would have been available for distribution as patronage dividends. The remaining section 1231 gain, treated as a gain from the sale of a capital asset held for more than 6 months, was income derived from sources other than patronage.

Depreciation was the object of several other revenue rulings. Rev. Rul. 74-303, I.R.B. 1974-25, 23, held that the various methods of depreciation calculation described in section 167 are available to cooperatives. However, the method of depreciation calculation used to determine funds available for deductible patronage refunds must be the same as that used to calculate net earnings reported for income tax purposes. Rev. Rul. 74-274, I.R.B. 1974-23, 14.

Rev. Rul. 74-327, I.R.B. 1974-27, 16, dealt with a section 521 cooperative that had certain depreciation disallowed for prior years that resulted in reduced expenses and greater patronage dividends payable for those years. This increase had to be treated as patronage income for those years, not the year of disallowance, and because the distribution was taking place after the 8½-month period following the close of the year in which the patronage occurred, deductions for patronage distributions were not available. Income from patronage sources remaining after

tax payment could be distributed as a nonqualifying patronage dividend.

Rev. Rul. 74-288, I.R.B. 1974-25, 7, gave an example of calculations to be used by a cooperative doing member and nonmember business to determine investment credit on section 38 property. Section 46 (d)(1)(c) requires an adjustment by cooperatives in the qualified investment with respect to section 38 property and in limits on the credit. The example demonstrates how proportions are to be used to make the necessary adjustments.

A section 521 cooperative operated with several branches and with a feed yard financed by some members in such a way that it was possible, under section circumstances, for patrons in different branches to receive different dividends for marketing identical amounts to the cooperative. Rev. Rul. 74-567, I.R.B. 1974-47, 9, permitted such treatment because the "equality of treatment" principle was not violated where the branches were separate units and patronage was calculated on a branch basis, and the varying treatment of patrons was tied to their different participation in the feed yard operation financing.

2 Federal Income Taxes

Nine times, following the adoption of the 16th (income tax) amendment to the Constitution of the United States, the Congress has enacted tax legislation dealing specifically with farmer cooperatives. In each instance, the distinct character of the cooperative form of doing business has been recognized. Congress also has clearly manifested a desire to foster these mutual, self-help institutions of farmers.

Substantial revisions were made in the Federal income tax laws relating to the tax treatment of cooperatives and their patrons in 1962[1] and again in 1966.[2] These revisions were designed to assure that amounts received by cooperatives in the course of their

[1]See section 17 of the Revenue Act of 1962 (Pub. L. 87-834, 76 Stat. 1045), which added subchapter T (sections 1381-3, 1385 and 1388) to the Internal Revenue Code of 1954. Unless otherwise stated, all citations in this section are to the Internal Revenue Code of 1954, as amended. The corresponding citation to Title 26 of the United States Code will be omitted.

[2]See section 211, Foreign Investors Tax Act of 1966 (Pub. L. 89-809, approved November 13, 1966, 80 Stat. 1580), amending subchapter T and section 6044 of the Internal Revenue Code relating to information reporting. In 1969, a "technical amendment" was added; see footnote 3, in this section.

business activities with their patrons are included in computing the income tax of either the cooperative or the patron, thus subjecting these amounts to a current single tax. Legislation in 1951 had attempted a "current single tax," but no specific statutory provisions on patrons' tax treatment were included.

In 1969, Congress again considered changes in the tax laws affecting cooperatives. It adopted the ninth enactment relating to farmer cooperatives—an amendment clarifying certain questions relating to pooling arrangements.[3] At the same time, it rejected a proposal that would have increased from 20 to 50 percent (over a 10-year period) the amount that must be paid in cash currently by a cooperative to qualify its patronage refunds as deductions in computing taxable income, and would also have required payment of the balance of the patronage refunds within 15 years.[4]

The Senate Finance Committee deleted the provision from its version of the Tax Reform Act of 1969 and directed its staff to undertake a study of problems in the taxation of cooperatives.[5] The Conference Committee omitted the provision and the 1969 Tax Reform Act became law without it. In a related move, the Conference Committee also requested the Treasury Department and congressional staffs to study problems in the tax treatment of cooperatives and report by January 1, 1972.[6]

Over the years, there has grown an extensive body of case law, regulations, and rulings on the taxation of cooperatives and their patrons. No single facet of cooperative functioning has received as much attention or indepth analysis. Numerous writers have dealt

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[3]Tax Reform Act of 1969, section 911, Pub. L. 91-172, approved December 30, 1969. See p. 449, for further discussion of the amendment.

[4]Section 531, Tax Reform Act of 1969, H.R. 13270, as passed by the House of Representatives on August 7, 1969. See H. R. Rep. 91-413 (pt. 1), 91st Cong., 1st sess. 167-9 (1969), House Comm. on Ways and Means, to Accompany H.R. 13270, and H.R. Rep. 91-413 (pt. 2), 91st Cong., 1st sess. 121-2 (1969), Supplemental Report of House Comm. on Ways and Means.

[5]S. Rep. No. 91-552, 91st Cong., 1st sess. 308-9 (1969), Senate Comm. on Finance, to Accompany H.R. 13270.

[6]H.R. Rep. No. 91-782, 91st Cong., 1st sess. 322-323 (1969), Conference Report to Accompany H. R. 13270. Some of the alternatives being considered in the study of cooperative taxation are reviewed by Harold Dubroff, Legislation Attorney, Joint Committee on Internal Revenue Taxation, in his talk entitled *Tax Reform Act of 1969 and Study of Cooperatives' Tax Problems by Congressional Committees,* at the Special Tax Conference, National Rural Electric Cooperative Association, Minneapolis, Minn., Dec. 1971. See footnote 125, in this section.

with the subject.[7] It is an ever-changing picture. And developments continue.[8]

A number of questions are now pending in the courts, and at the time this material was prepared, the Internal Revenue Service[9] was considering regulations under the 1966 and 1969 amendments to the law. Also under consideration was the issuance of additional revenue rulings and revenue procedures intended to clarify several matters of interpretation under the statutes and regulations.[10]

The taxation of cooperatives and their patrons under existing law, discussed in more detail in subsequent sections, can best be understood in the context of their past economic and income tax status.

Distinctive Characteristics of Cooperatives

The tax laws have always recognized the distinctive characteristics of the cooperative form of doing business.

Farmers join together in cooperatives to market their products and to purchase their farm supplies and farm business services. They do this to get a better price for their product, to serve themselves at cost, and thereby increase their farm income—not, as we shall see, to obtain a tax advantage unavailable to others.

Farmers look upon their cooperatives as extensions of their own farming operations—as the marketing and purchasing departments of their own farms.

Although not organized for profit, a farmer cooperative is organized for the financial benefit of its members. It differs,

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[7]See list of published material relating to taxes on p. 469. The listing, by no means exhaustive, is presented by date of publication. Treatment ranges from a consideration of broad policy and constitutional questions to analysis of old as well as current law, rulings and regulations designed to provide detailed guidelines for cooperatives and their advisors. No attempt is made to catalog the material; the reader being left a choice based on author, title, and publication date.

[8]See footnotes 5 and 6, in this section.

[9]The Internal Revenue Service is the part of the Treasury Department charged with the duty of collecting Federal taxes. Prior to 1953, it was known as the "Bureau of Internal Revenue." All "Internal Revenue" rulings will be cited herein as those of the "Service," although made when the name was "Bureau."

[10]Harmanson, Jr., *The Cooperative Tax Picture,* Cooperative Accountant, Winter 1968, 4; and Harmanson's reports to the annual meetings of the National Council of Farmer Cooperatives, Hollywood, Fla., Jan. 1970, Washington D.C., Jan. 1971, and Freeport, Bahamas, Jan. 1973.

though, from other commercial enterprises because, in a cooperative, the financial benefits flow to the patrons on the basis of their patronage. In other businesses, these benefits go to the owners, who may or may not be patrons of the business, not on the basis of patronage but according to their investment in the enterprise.

Cooperatives differ from other business organizations in at least four important ways:

1. *Member Ownership and Control.*—A first basic principle of a farmer cooperative is that ownership and control be in the hands of the farmers who use its services—for marketing or for obtaining supplies or services. Control is exercised by the owners as member-patrons rather than as investors. No other form of business has a comparable patron-owner relationship.

2. *Nonprofit Organizations.*—Operations of a cooperative are on a cost basis. Amounts realized from operations over and above expenses belong to the farmers who patronize the cooperative.

Since costs cannot be estimated accurately in advance, patrons of a cooperative usually pay the "going or competitive price" for goods or services; and generally receive an advance for products marketed that is less than the actual value of the product. Adjustments are made at the end of the year when costs are known. The amount of any necessary adjustment then goes to member-patrons as refunds based on patronage.

The cooperative thus operates at cost and not to make a profit for itself or for nonpatron investors.

3. *Returns on Capital Limited.*—Members of a cooperative are primarily interested in the benefits they derive as patrons of the organization. Since benefits in a cooperative are distributed to patrons on the basis of their use of its services, such benefits do not enhance the value of shares of stock or provide a return on invested capital.

Hence, members of a cooperative must provide most of its capital either by direct subscription or by investment of their patronage allocations. The incentives which cause persons to invest in corporate stocks are not present in the case of cooperative stock. For this reason the capital of a cooperative can, for the most part, come only from its member-patrons.

4. *Obligation to Finance.*—While the obligation of members to finance is not listed first, it is of prime importance. A cooperative

is organized for the benefit of its members as patrons and not as investors. Member-patrons are thus the persons primarily interested in the success of the enterprise and, as they use its services, they assume the basic responsibility of providing capital.

Although differing in many ways from other corporations, farmer cooperatives are an integral part of our private enterprise system. They enable the individual farmer to join with his neighbor to gain the volume and market strength necessary to compete in our business economy. Whether farmers operate their cooperative to market milk, cotton, grain, livestock, vegetables, citrus fruits, or some other commodity; or to purchase fertilizer, seed, insecticides, or other farm supplies or services, they are operating in the best tradition of the American economy.

Historical Background

The Revenue Act of 1913, the first tax measure enacted after the 16th amendment, did not specifically mention cooperatives. It did, though, exempt certain types of nonprofit concerns, including "agricultural and horticultural organizations."[11]

The Treasury Department at first construed this language to include, as exempt, cooperative dairies without capital stock making "patrons dividends based on the percentage of butter fat in milk furnished" the cooperative.[12] This ruling was replaced within a few months by one holding that cooperative dairies, whether issuing capital stock or not, were required to file returns of annual net income under the Act since they did not "appear to fall within" any of the exempted classes. In their returns they were allowed to include in their deductions from gross income the amount "actually paid" to members and patrons for milk, but any amount retained at the end of the year over and above expenditures was returnable as net income and taxable.[13] Insofar as applicable, this same ruling was also extended to mutual or cooperative telephone companies, farmers' insurance companies, and like organizations.

An extremely narrow exemption for agency marketing cooperatives which dealt only with members was included in the 1916

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[11]38 Stat. 166, 172.

[12]Art. 92 of Income Tax Regs. No. 33, p. 62 (Jan. 5, 1914), T.D. 1944, filed as Supp. with 16 Treas. Dec. Int. Rev. (1914).

[13]T.D. 1996, 16 Treas. Dec. Int. Rev. 100 (1914).

Act.[14] Five years later, in the 1921 Act, these provisions were broadened to include farmer cooperatives acting as purchasing agents for members.[15]

The bare language of this statute required substantial interpretative regulations to accommodate the increasingly complex structures of farmer cooperatives as they were being organized and operated in the early 1920's. Thus, in regulations published in 1921, the issuance to farmer-producers of capital stock having limited dividend rights was authorized. In 1922, regulations under the 1921 Act authorized the accumulation of reasonable reserves. The term "producer" rather than "member" appeared in regulations under the 1924 Act, clearing the way for limited dealings with nonmembers.

These practices authorized by the Treasury Department all found their way into the Revenue Act of 1926.[16] In 1934, [17] the statute was amended, permitting business done with the United States to be disregarded in determining the right to exemption.

The next 17 years brought no further changes in the 1926 law until the Congress enacted section 314 of the Revenue Act of 1951.[18] Section 314 repealed none of the existing law, but it added new tax treatment for associations qualifying under the provisions that had theretofore conferred complete exemption.[19] In other words, compliance with the "exemption" provisions of the statute for taxable years beginning after December 31, 1951, no longer gave exemption. It merely authorized a qualifying association to

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[14]39 Stat. 756, 767, Sec. 11, Eleventh, exempted "Farmers', fruit growers', or like associations, organized and operated as a sales agent for the purpose of marketing the products of its members" and turning back to them, on a patronage basis, the proceeds less selling expenses.

[15]42 Stat. 227, 253.

[16]44 Stat. 9, 40. Sec. 231(12) of this Act, in summary, provided that a cooperative might act as principal as well as agent and thus take title to goods marketed and purchased; that it might accumulate reasonable reserves; that it might issue voting stock to producers with limited dividend rights and that it might carry on as much as 50 percent of its business with nonmembers, so long as purchasing business for nonmember nonproducers is limited to 15 percent.

[17]48 Stat. 680, 701.

[18]65 Stat. 452, 491.

[19]It is clear that Congress had the right to exempt agricultural cooperatives from the payment of Federal income taxes. *Flint* v. *Stone Tracy Co.,* 220 U.S. 107 (1911); *Brushaber* v. *Union Pacific Railroad Co.,* 240 U.S. 1 (1916), L.R.A. 1917 D 414, Ann. Cas. 1917 B 713; *Stanton* v. *Baltic Mining Co.,* 240 U.S. 103 (1916). The special or different treatment under the 1951 law is not unusual and likewise is

make certain deductions and other adjustments in the computation of its statutory net income under the Internal Revenue Code. Like nonexempt cooperatives, such complying associations, now erroneously labeled "exempt," were also authorized to *exclude* from gross income patronage refunds which they were under a prior mandatory obligation to make to their patrons.[20]

The complete revision of the Internal Revenue Code in 1954 made no substantive changes in the law as it stood after the 1951 Act became effective, but new section numbers were assigned. Section 101(12)(A) of the 1939 Code became section 521 of the 1954 Code, and section 101(12)(B) of the 1939 Code became section 522 of the 1954 Code.

The statutory provisions relating to farmers' marketing and farm supply associations as they appeared following the 1954 revision of the Internal Revenue Code were as follows:[21]

Sec. 521. Exemption of Farmers' Cooperatives From Tax.

(a) *Exemption From Tax.*—A farmers' cooperative organization described in subsection (b) (1) shall be exempt from taxation under this subtitle except as otherwise provided in section 522. Notwithstanding section 522, such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

(b) *Applicable Rules.*—

(1) *Exempt Farmers' Cooperatives.*—The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds

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legal. The Internal Revenue Code is replete with differing rules on differing groups, classes or types of taxpayers. Silverstein, *Special Situations under the Federal Income Tax Law,* Mimeo. by National Council of Farmer Cooperatives, 1955, 29 pp.

[20]See "Taxation of Nonexempt Cooperatives," p. 364.

[21]68A Stat. 176-8, 26 U.S.C. 521-522.

of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) *Organizations Having Capital Stock.*—Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) *Organizations Maintaining Reserve.*—Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) *Transactions With Nonmembers.*—Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(5) *Business For The United States.*—Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

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Sec. 522. Tax on Farmers' Cooperatives.

(a) *Imposition Of Tax.*—An organization exempt from taxation under section 521 shall be subject to the taxes imposed by section 11 or section 1201.

(b) *Computation Of Taxable Income.*—

(1) *General Rule.*—In computing the taxable income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under this chapter)—

(A) amounts paid as dividends during the taxable year on its capital stock, and

(B) amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

(2) *Patronage Dividends, Etc.*—Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate) shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521. Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.

These two sections of the law provide essential background material for a clear understanding of the current tax treatment of cooperatives and their patrons, although the Revenue Act of 1962 repealed section 522[22] and made a few technical changes in section 521.

Taxation of "Exempt" Cooperatives Under 1951 Act

As previously stated, compliance with the various requirements of section 521 no longer gave farmer cooperatives exemption from income tax. It authorized a qualifying association to apply section 522 of the Internal Revenue Code of 1954 in computing taxable net income.

Under section 522, taxable net income of a qualifying cooperative was subject to normal, surtax, and capital gains taxes imposed on corporations generally. In computing taxable income, a cooperative qualifying under section 521 could take the usual deductions allowed corporations and two other deductions; namely: (1) Amounts paid during the taxable year as dividends on capital stock[23] and (2) amounts paid to patrons, or allocated and disclosed to each patron, with respect to revenues not derived from patronage. The amounts covered by the second deduction included, for example, rents received, investment revenues, gain on the sale of depreciable property and capital assets, and amounts from business done with the U.S. Government.

Section 522 also stated that patronage "dividends, refunds, and rebates to patrons" with respect to their patronage in the same or preceding years, and whether paid in cash or several noncash forms "shall be taken into account in computing taxable income in

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[22]Although repealed, section 522 continues to apply with respect to patronage refunds made before December 31, 1962 (or after this date with respect to patronage occurring during taxable years beginning before January 1, 1963, and also with respect to redemptions or cash retirements of patronage refunds after that date if the noncash refunds were actually made with respect to an earlier year). Sec. 17(c) of Pub. L. 87-834, 76 Stat. 1051. Also compare the repealed section 522 with the current section 1382(c) of the Code authorizing essentially the same deductions.

[23]Defined in the regulations as including "common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidences of a proprietary interest in a cooperative association." 26 C.F.R. 39.101(12)-3(d).

the same manner as in the case of a cooperative organization not exempt under section 521." Congress thereby expressly recognized that farmer cooperatives could exclude patronage refunds from gross revenues in computing their Federal income tax.[24]

A patronage refund is a distribution by a cooperative of the margin over expenses which it is under a prior mandatory obligation to make to its patrons. This will be discussed in more detail in a subsequent section.

Patronage refunds could be excluded by a cooperative qualifying under section 521 if the allocation were made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative. The regulations made it clear that the prior mandatory obligation referred to above must exist. This obligation could be in the State law, the cooperative's organization papers, marketing contracts, or other valid contractual form.[25]

Taxation of Nonexempt Cooperatives

During the congressional hearings on the tax treatment of cooperatives in 1951, the Treasury Department submitted a memorandum on its position with respect to the *exclusion* at the corporate level of patronage refunds from taxable income. The memorandum[26] is quoted in full, not just for historical value, but for the reason that the rules discussed still apply in cases where subchapter T treatment is inapplicable.

For example, subchapter T, relating to the tax treatment of cooperatives and their patrons, does not apply to either (a) mutual ditch or irrigation companies, or electric or telephone cooperatives exempt under section 501 (c) (12), or (b) presently taxable cooperatives which are engaged in furnishing electric energy, or pro-

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[24]The quoted language from section 522 has been described as the first legislative recognition of the longstanding administratively allowed and court approved right of cooperatives, whether exempt or not, to exclude from taxable income patronage allocations made pursuant to a preexisting legal obligation. See, *e.g.*, Logan, *Federal Income Taxation of Farmers' and Other Cooperatives,* 44 Texas L. Rev. 250, at 286 (1965).

[25]26 C.F.R. 39.101(12)-4(a).

[26]Hearings Before House Committee On Ways and Means, 82d Cong., 1st sess., on Revenue Revision of 1951 (pt. 3), pp. 2858-2859 (1951).

viding telephone service, to persons in rural areas.[27] Electric and telephone cooperatives and their patrons are still governed by the previously applicable law.[28]

The Treasury Department's memorandum is as follows:

> A taxable cooperative is a cooperative other than a farm cooperative specifically exempt from income tax under section 101 (12) of the Internal Revenue Code. It is subject to the corporate tax. However, if a cooperative has agreed at the time of any sale to or purchase from its patrons to allocate or return to them any net proceeds of the current year in proportion to patronage, it can compute its tax only on the amount of its net proceeds which have not been so allocated or returned as "patronage dividends." It should be noted that, if only members of the cooperative may receive patronage dividends, the cooperative may not omit from gross income the portion of any distributions to members which represents profits from dealings with nonmembers.
>
> This treatment of patronage dividends has been a long-established practice of the Bureau of Internal Revenue. Such treatment, at the time of its adoption, was based on the theory that amounts allocated or returned as patronage dividends represented a reduction in cost to the patron of goods purchased by him through the cooperative or an additional consideration due the patron for goods sold by him through the cooperative.
>
> One of the earliest Bureau rulings on the matter was under the Revenue Act of 1913. That act exempted from the income tax mutual savings banks not having any capital stock represented by shares. However, it prescribed a rather different treatment for mutual fire insurance companies whose members made premium deposits to provide for losses and expenses. These

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[27]Section 1381(a)(2)(A) and (C), Internal Revenue Code of 1954, as amended by the Revenue Act of 1962.

[28]See S. Rep. No. 1881, Report of the Committee on Finance on the Revenue Act of 1962, 87th Cong., 2d sess. 113 (1962). See "Electric and Telephone Cooperatives," at p. 458.

insurance companies were not required to include in taxable income any portion of the premiums returned to their policyholders as so-called policy dividends. Income from other sources and premium payments retained by these companies for purposes other than the payment of losses and expenses and reinsurance reserves were, however, taxable. The Treasury by analogy adopted in 1914 a similar rule for farm cooperative associations which were not eligible for exemption under the 1913 act and permitted them to exclude patronage dividends from gross income. (See T. D. 1996.) The Regulations under the 1916 act, like those under the 1913 act, provided that any cooperative association which could not qualify for the statutory exemption of farm cooperatives because it did not, as then required by the statute, act strictly as agent but purchased produce from members with a view toward selling it for gain, might nevertheless exclude from gross income all amounts paid to members on the basis of quantity of goods handled for them.

Treasury rulings consistent with the above have been issued during that period until the present time. Examples are T.D. 2737 (1918), IT 1499 (1922), IT 1566 (1923), GCM 12393 (1933), GCM 17895 (1937). The present tax treatment of patronage dividends thus represents a long-established administrative practice.

This practice has been recognized by the courts as valid. Examples of recent decisions are *Associated Grocers of Alabama* v. *Willingham,* 77 F. Supp. 990; *Peoples Gin Company* v. *Comm'r.,* 118 F. (2d) 72; and *Fountain City Co-op Creamery Association* v. *Comm'r.,* 172 F. (2d) 666. In an opinion which exhaustively reviews the administrative and judicial precedents in the matter, the District Court for the Northern District of Iowa concluded: "This practice * * * has been recognized and approved by the courts." (86 F. Supp. 201,238.) That court also specifically held:

"1. That the Treasury Department rulings providing that under certain conditions a cooperative may exclude from its gross income for Federal income tax purposes

amounts allocated as patronage dividends are not so unreasonable or so plainly inconsistent with the Internal Revenue Code as not to be followed" (p. 237).

Moreover, it does not seem unimportant that during this long period of uninterrupted administrative practice, the Congress has not changed the rule by legislation, even though during a period of over 30 years it has often reenacted various revenue acts. It has been indicated by the Supreme Court that where there has been a contemporaneous administrative construction of a congressional enactment followed by long-continued administrative practice, reenactment "amounts to an implied legislative recognition and approval of the executive construction of the statute" (*National Lead Co.* v. *U.S.,* 252 U.S. 140).

Farmer marketing and farm supply associations with bylaws that set forth a definite preexisting obligation to distribute to patrons a portion of net margins as patronage refunds, could exclude such refunds from income for Federal income tax purposes, regardless of whether the corporate name contained the word "cooperative."[29]

The right to *exclude* patronage refunds as just outlined was not confined to farmer organizations. This has been recognized by the Treasury Department and by the courts.[30]

One of the earliest cases establishing the principle in question is *Appeal of Paducah & Illinois Railroad Company.*[31] In that case, a bridge company was organized and completely owned by a

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[29]Rev. Rul. 55-26, 1955-1 Cum. Bull. 338.

[30]Statement by A. Lee Wiggins, Under Secretary of the Treasury, in hearings before the House Committee on Ways and Means, 80th Cong., 1 st sess. (pt. 4), p. 1881 (1947): "Under present law, farm cooperative associations are authorized to exclude patronage dividends from gross income. This, however, is not the exclusive privilege of cooperative associations. The privilege is available to any corporation which makes payments to its customers under the conditions prescribed by the Commissioner of Internal Revenue and the courts." See also the cases cited in the next footnote. For a recent discussion of this subject see Volkin, *Any Corporation Can Achieve A Tax Status Comparable to Cooperatives,* Reprint, News for Farmer Cooperatives, Oct. 1966, published by Farmer Cooperative Service (FCS), U.S. Dept. Agr.

[31]*Appeal of Paducah & Illinois Railroad Co.,* 2 B.T.A. 1001 (1925). See *Uniform Printing and Supply Co.* v. *Commissioner,* 88 F. 2d 75 (7th Cir. 1937);

number of railroads. The bridge company borrowed $5 million and built a bridge used jointly by the owning railroads. The company was obligated by contract to account to the several owners in preferred stock for any rates, tolls, and charges that the owners paid for using the bridge which were in "excess" of the pro rata shares of the owners for the operating and maintenance expenses of the bridge company.

The "excess" was used to retire the bonds, and as they were retired, a like amount of preferred stock was to be issued to the owning railroads. The net effect of the arrangement was to make the bridge company operate as a cooperative. Its operations for the year were adjusted to cost with any excess refunded to the patrons (the member railroads which used the bridge) in proportion to their use of the facility.

The Board of Tax Appeals held that this resulted in no taxable income to the bridge company. It said:

> In effect, the railroad companies agreed among themselves * * * to construct the bridge over the Ohio River and to create for that purpose the taxpayer corporation, and to share the cost of that facility in the manner laid down in the agreements. Briefly, charges were to be made for the services rendered in amounts

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United Cooperatives, Inc., 4 T.C. 93 (1944); *Broadcast Measurement Bureau, Inc.,* 16 T.C. 988 (1951); *Colony Farms Cooperative Dairy, Inc.,* 17 T.C. 688 (1951); *Clover Farm Stores Corp.,* 17 T.C. 1265 (1952); *Southwest Hdwre. Co.,* 24 T.C. 75 (1955); *United States* v. *Mississippi Chemical Co.,* 326 F. 2d 569 (5th Cir. 1964), *affirming* 197 F. Supp. 490 (S.D. Miss. 1961); *Certified Grocers of Florida, Inc.* v. *United States,* 18 AFTR 2d 5012 (M.D. Fla. 1966); *Union Equity Cooperative Exchange,* 58 T.C. 397 (1972). In Rev. Rul. 68-228, 1968-1 Cum. Bull. 385, the Service announces that in determining patronage refund deductions under subchapter T, it will not follow *Mississippi Chemical* because "net earnings" from member business were not reduced by capital stock dividends. Also *Mississippi Chemical* is not followed in *Des Moines County Farm Service Co.* v. *United States,* 324 F. Supp. 1216 (S.D. Iowa 1971), *affirmed,* 448 F. 2d 776 (8th Cir. 1971), and *Union Equity Cooperative Exchange, supra.* Rev. Rul. 68-228 uses an example of a cooperative that did 50 percent of its business with members and 50 percent with nonmembers. This is *only* an *example* says Rev. Rul. 72-602, 1972-2 Cum. Bull. 510, and it is not intended to state a rule with respect to the amount of nonmember business a "nonexempt" cooperative may have. Therefore, Rev. Rul. 68-228 is modified by Rev. Rul. 72-602 to the extent that it implies that a "nonexempt" cooperative that deals with nonmembers at a "profit" may do 50 percent or less of its business with members and still qualify under subchapter T of the Code. See footnote 218 in this section.

deemed sufficient to pay all of the expenses of the taxpayer and in addition to retire its indebtedness at maturity. In the first instance, bills were rendered monthly upon a traffic basis, but if the amounts collected under these bills were insufficient to meet the charges of the taxpayer, supplemental bills were rendered for each of the several months, making up the deficits and calling for contributions by the railroad companies in the proportions of their original payments to the taxpayer. To the extent that the taxpayer's funds derived either under the original or the secondary bills were devoted to the retirement of bonds, the railroad companies were to receive preferred stock in the exact amount of their contributions used for that purpose. This was in accordance with the contract entered into July 1, 1915, by the two original participating railroad companies, and after September 1, 1920, participated in by the Illinois Central.

From the beginning, the funds so contributed by the railroad companies were earmarked partly for the ordinary expenses of the taxpayer and partly for its capital requirements. In so far as the contributions were used or to be used for ordinary expenses, interest, taxes, and dividends, there can be no question that the railroad companies were making payments for services rendered by the taxpayer, which constituted expenses to themselves and income to the taxpayer. *To the extent, however, that their contributions were from the beginning required and, under the contract of July 1, 1915, were contemplated to be used for the retirement of debt and offset by preferred stock issued or to be issued to the railroad companies, the contributions were not expenses of the railroad companies, and were not income to the taxpayer. They were, on the one hand, investments of capital, and, on the other, receipts of capital for which stock was required to be issued.* * * *

* * * *From the beginning the funds so paid represented contributions by the railroad companies, for which they had an absolute right to the issuance to them of preferred stock.* We are also aware, as noted by

the Commissioner in his brief, that no competent evidence was offered that preferred stock ever was actually issued to the railroad companies, and we have made no finding of fact with reference thereto. *As we view the case, whether stock was actually issued at the time is immaterial.* The railroad companies from the moment of their respective payments were entitled under their contracts to an accounting as to the disposition made of the funds so paid and to preferred stock in respect of their capital contributions. The stock was issuable on demand if not actually issued. Under these circumstances, the deficiency determined by the Commissioner must be disallowed. (Emphasis supplied.)

One of the leading farmer cooperative tax cases is *United Cooperatives, Inc.*[32] This cooperative was under contractual obligation to account to its patrons for all amounts received by the cooperative over operating costs and expenses and amounts which the cooperative was permitted to pay as dividends on stock. Under its bylaws the cooperative had a mandatory obligation to return this excess amount in cash or stock.

The Tax Court held that all amounts which the cooperative was under a mandatory obligation to return to its patrons in accordance with their patronage were *excludable* from gross income. The board of directors had discretion to determine, within limits, the amount of dividends payable on capital stock. The court said that net margins equal to the maximum permissible dividends under the bylaws were not subject to a mandatory obligation, and, therefore, were taxable to the cooperative.[33]

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[32]4 T.C. 93 (1944).

[33]Compare this holding with the rule applied under subchapter T in Rev. Rul. 69-621, 1969-2 Cum. Bull. 167. In this ruling, dividends on stock *actually paid* by a cooperative were less than the maximum amount permitted under the bylaws. The bylaws also required the net amount remaining after payment of dividends on stock to be distributed on a patronage basis to all patrons. The cooperative was allowed to deduct as a patronage refund under section 1382 of the Code the net amount *remaining after* payment of the dividends on stock. See also Rev. Rul. 70-233, 1970-1 Cum. Bull. 180, holding that a cooperative qualifying under section 521 is entitled to a deduction for dividends paid on its capital stock in the year it was "qualified," even though the dividends were declared in the prior year when it had not qualified. See Rev. Rul. 62-131, 1962-2 Cum. Bull. 94, holding that the date of payment, rather than the date of declaration, constitutes the date of distribution of a dividend.

Prior to this decision, the Board of Tax Appeals had held that where an association had adopted a bylaw creating a definite liability on the part of the association to credit its patrons with net margins, the association was entitled to deduct such amount in computing its income taxes.[34]

The Board of Tax Appeals had also held that where an association had an "oral understanding" that there would be paid to its stockholders in addition to the amount paid to them at the time of the delivery of their grain "an amount equal to the difference between such amount plus the cost of reselling the wheat, and the price at which the wheat was resold," this amount could be deducted in determining the taxable income of the association, even though the patronage refund had not been declared payable and although the amount in question "was eventually wiped out by operating losses."[35]

In another case, the board of directors of an association within the fiscal year adopted a resolution under which part of the net margin was to be distributed on a patronage basis in cash and part in a patrons' equity reserve. The latter amounts were apportioned to patrons during the succeeding fiscal year. The action of the board was approved at the annual meeting of stockholders. The Board of Tax Appeals held that the amounts placed in the patrons' equity reserve were excludable from gross income.[36]

Later U.S. Tax Court and Federal court decisions made it clear, however, that the rule was that only patronage refunds distributed pursuant to a preexisting obligation either in the form of cash or by offset against a capital investment in, or loan to, the cooperative (evidenced by capital stock, certificates of indebtedness, notes, book credits, or in some other manner which discloses to the patron the dollar amount of his interest) were excludable from gross income.[37]

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[34]*Appeal of the Trego County Cooperative Association,* 6 B.T.A. 1275 (1927); *Anamosa Farmers Creamery Company,* 13 B.T.A. 907 (1928); *Farmers Union Cooperative Association,* 13 B.T.A. 969 (1928). In *Anamosa* the Board said: "In this situation neither the basis of accounting nor the fact that no cash was paid to the patrons in the taxable year is material."

[35]*Home Builders Shipping Association,* 8 B.T.A. 903 (1927). At p. 909 the Board said: "It is to our minds immaterial that the liability * * * has not, as yet, been paid. There was no evidence that the petitioner never intended to pay it."

[36]*Midland Cooperative Wholesale,* 44 B.T.A. 824 (1941).

[37]*Smith & Wiggins Gin, Inc.* v. *Commissioner,* 341 F. 2d 341 (5th Cir. 1965); *United States* v. *Mississippi Chemical Co.,* 326 F. 2d 569 (5th Cir. 1964); *Pomeroy*

Where the State law, the organization papers, or other contractual arrangements between the cooperative and the patrons do not create the required preexisting obligation, it has been held that patronage refunds may not be excluded from gross income.[38]

As one author has observed:

> The cooperatives' income tax cases constituted a long course of administrative and judicial wallowing among

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Cooperative Grain Co. v. *Commissioner,* 288 F. 2d 326 (8th Cir. 1961); *Farmers Cooperative Co.* v. *Commissioner,* 288 F. 2d 315 (8th Cir. 1961); *Albany Creamery Association,* 51-1 U.S. Tax Cas. ¶ 9526 (D. Ore. 1950); *Union Equity Cooperative Exchange,* 58 T.C. 397 (1972); *Southwest Hardware Co.,* 24 T.C. 75 (1955); *Colony Farms Cooperative Dairy, Inc.,* 17 T.C. 688 (1951); *Midland Cooperative Wholesale,* 44 B.T.A. 824 (1941); *Farmers Union Cooperative, Inc.* v. *United States,* 480 F. 2d 548 (5th Cir. 1973) a case arising *Co.,* 13 B.T.A. 907 (1928); *Home Builders Shipping Association,* 8 B.T.A. 903 (1927); *Farmers Cooperative Co.* v. *Birmingham,* 86 F. Supp. 201 (N.D. Iowa 1949); *San Joaquin Valley Poultry Producers Association* v. *Commissioner,* 136 F. 2d 382 (9th Cir. 1943); *Dr. P. Phillips Cooperative,* 17 T.C. 1002 (1951); *Otsego County Cooperative Association, Inc.,* CCH Dec. 19,137 (M) Dkt. No. 28479, July 31, 1952, memorandum opinion by Judge Rice. If an association is under obligation to pay patronage refunds to its members only, it may not exclude amounts received from business done with nonmembers, even though it distributes such amounts as patronage refunds to its members. S.M. 2595, III-2 Cum. Bull. 238 (1924), declared obsolete but not revoked or superseded by Rev. Rul. 70-319, 1970-1 Cum. Bull. 284. See discussion at footnotes 134 and 135, this section. Note that the rule expressed in S. M. 2595 is followed in *Iberia Sugar Cooperative, Inc.* v. *United States,* 480 F. 2d 548 (5th Cir. 1973), a case arising under Subchapter T. See footnote 46 in this section. *Cf. Bakers Mutual Cooperative Association* v. *Commissioner,* 117 F. 2d 27 (3rd Cir. 1941), *affirming* 40 B. T. A. 656 (1939); *Fruit Growers' Supply Co.* v. *Commissioner,* 56 F. 2d 90 (9th Cir. 1932), *affirming,* 21 B. T. A. 315 (1930).

The courts have also recognized the right of workers' cooperatives—one of the oldest types—to exclude patronage refunds from gross income. *Linnton Plywood Association* v. *United States,* 236 F. Supp. 227 (D. Ore. 1964) and *Puget Sound Plywood, Inc.,* 44 T.C. 305 (1965), *acq.,* 1966-2 Cum. Bull. 6. Rev. Rul. 61-47, 1961-1 Cum. Bull. 193 (now revoked by Rev. Rul. 71-439, 1971-2 Cum. Bull. 321, which acknowledges *Linnton Plywood* and *Puget Sound* as authority), had expressed a contrary position holding that amounts distributed by worker cooperatives on the basis of man-hours worked were not "true" patronage refunds and therefore not excludable by the cooperative although such distributions were pursuant to a preexisting obligation.

[38] *Farmers Union State Exchange,* 30 B.T.A. 1051 (1934); *Juneau Dairies, Inc.,* 44 B.T.A. 759 (1941); *Cooperative Oil Association, Inc.* v. *Commissioner,* 115 F. 2d 666 (9th Cir. 1941); *Peoples Gin Co.* v. *Commissioner,* 118 F. 2d 72 (5th Cir. 1941), *affirming* 41 B.T.A. 343 (1940); *Associated Grocers of Alabama* v. *Willingham,* 77 F. Supp. 990 (N.D. Ala. 1948); *Gallatin Farmers Co.* v.

various theories before the mandatory obligation and reinvestment theory was firmly established.[39]

However tortuous the route, the principle is well established in the tax cases. It is aptly expressed by the Tax Court in *United Cooperatives, Inc.*, as follows:

> The fact that member patrons were under obligations with regard to the purchase of petitioner's stock under certain circumstances and that petitioner had a right to apply a part of the "patronage dividends" to a satisfaction of such obligations, is immaterial. It does not affect the right of the member patrons to receive "patronage dividends," but merely constitutes a permanent directive as to their application. The result of the procedure set up by petitioner's bylaws was as if the stockholder member who was under obligation to purchase additional stock had received, in cash, the "patronage dividend" and had thereupon applied this sum to the payment of his stock. The stock, when thus paid and issued to him, was not in the nature of a stock dividend, but represented an additional investment on his part to the capital of the corporation out of his savings from the annual transactions with petitioner.[40]

When the money provided by the farmer is allocated to him under his contract with his cooperative, he and the cooperative have performed the terms of their patronage agreement. The fact that under this agreement, the cooperative's directors have discretion to determine the portion of the net margins patrons should invest in the capital of the cooperative (be it stock, or certificates of interest, or book equities in revolving-fund capital), does not preclude the obligation to pay the patronage refund from being

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Commissioner, 132 F. 2d 706 (9th Cir. 1942); *American Box Shook Export Association* v. *Commissioner,* 156 F. 2d 629 (9th Cir. 1946), *affirming* 4 T.C. 758 (1945); *Fountain City Cooperative Creamery Association* v. *Commissioner,* 172 F. 2d 666 (7th Cir. 1949), *affirming* 9 T.C. 1077 (1947). *Cf. Druggists' Supply Corporation,* 8 T.C. 1343 (1947); *Union Fishermen's Cooperative Packing Co.* v. *Earle* (*Same* v. *Maloney*), 121 F. Supp. 373 (D. Ore. 1954).

[39]Nieman, *Multiple Contractual Aspects of Cooperatives' Bylaws,* 39 Minn. L. Rev. 135, 136 (1955).

[40]4 T.C. 93, 108 (1944). For a recent application of the principle see Rev. Rul. 70-13, 1970-1 Cum. Bull. 272, involving telephone cooperatives discussed at footnote 44 in "Taxes—State, Local, and General," p. 353.

mandatory. Nor is it pertinent that the stock certificates, or equities might not be redeemed until some future time; or that the farmer has put his money in capital or other interests that may have no current fair market value.

It may seem unrealistic to some to say that the farmer has realized income of 100 cents on the dollar when his patronage refund is offset by an investment in stock or other capital interests which may have no immediate fair market value. Of course, the farmer has received the benefit of the service provided by his cooperative. Who, then, can say that this has not given him full economic value for his money? Moreover, income does not cease to be income because it has been invested or loaned, even though the investment or loan may be a poor one.[41]

Sometimes it may be difficult to work out a method by which an antecedent contract obligating the cooperative to distribute margins to patrons is created. With respect to members of the cooperative, the State law, the articles of incorporation, and the bylaws constitute the contract among the members one with another and also between the members and the association. It is, therefore, possible to show that the contract exists by reason of the State law, or, if that is not the case, to create the necessary antecedent obligation by an appropriate provision in the articles or bylaws.

With respect to both member and nonmember patrons, it is also possible to create the necessary antecedent obligation in a marketing contract or other agreement. In such cases, care must be taken that all members and all patrons actually do execute some formal written instrument by which they become bound to the association and the association becomes bound to them to make patronage distributions.

Many cooperatives do a substantial business with nonmembers. It has always been a most vexing problem to establish the necessary antecedent contract with such persons.

Some cooperatives have conspicuously posted excerpts from the articles and bylaws in their place of business; others printed the applicable excerpts on order blanks, sales receipts, advertising material, and other communications between the patrons and the association. Posters or printed material properly worded and conscientiously posted and distributed and explained, might persuade courts to hold that the cooperative offered to do business with the nonmember patron on a cooperative patronage basis and

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[41] *Cf. Brown* v. *Commissioner,* 220 F. 2d 12 (7th Cir. 1955).

that the patron accepted this offer by doing business with the cooperative.[42]

Some cooperatives follow the plan of offering every patron an opportunity to become a member at the time of his first transaction with the cooperative. The patron is asked to sign a membership application and agree that his first patronage allocations shall be applied on his membership fee. This plan, if acceptable to the patrons and adhered to and if workable in the business of the cooperative, would accomplish the purpose of making every patron a member.

Amounts authorized by members to be deducted from sales proceeds for products marketed or to be added to the cost of purchases made for the express purpose of being used by the cooperative as capital are also not taxable to the cooperative.[43] This is because money furnished a corporation for capital purposes is not income to the corporation.[44] Such amounts should not be confused with patronage refunds, since the contributions to capital from patronage refunds depend upon the existence of a net margin between a cooperative's gross receipts and its costs and expenses.[45]

An early ruling of the Internal Revenue Service shows how a cooperative's net taxable income is computed. Appropriate handling of margins from both members and nonmembers is considered. The ruling emphasizes that margins from nonmember business may not be distributed to members in the "guise of rebates" and thereby become deductible by the cooperative.[46] In the absence of evidence to the contrary, the ruling assumes that "the dealings with members and nonmembers are equally profitable."

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[42]But see "consent" bylaw requirements under subchapter T of the Internal Revenue Code of 1954, and text, *infra,* pp. 435 and 437.

[43]Rev. Rul. 54-244, 1954-1 Cum. Bull. 104.

[44]See *Edwards* v. *Cuba Railroad Co.,* 268 U.S. 628 (1925); *Appeal of Paducah & Illinois Railroad Co.,* 2 B.T.A. 1001 (1925); L.S. Hulbert, *Money Received As Capital Is Not Income,* 10 News for Farmer Cooperatives 7 (Jan. 1943); *United Grocers, Ltd.* v. *United States,* 308 F. 2d 634 (9th Cir. 1962), *affg.* 186 F. Supp. 724 (N.D. Calif. 1960), where the court analyzed and spelled out in great detail all the requirements for capital payments by cooperative patrons.

[45]See "Capital Retains," at p. 443.

[46]A. R. R. 6967, III-1 Cum. Bull. 287 (1924). See *Iberia Sugar Cooperative, Inc.* v. *United States*, 480 F. 2d 548 (5th Cir. 1973), holding that proceeds from nonmember business allocated to members were not patronage refunds as defined in sec. 1388(a) of Internal Revenue Code of 1954 and therefore were not deductible by the cooperative under sec. 1382(b)(1) of the Code. See also *Farmers*

Taxability of Patronage Refunds to Patrons—Pre-1962 Treatment

For many years, first in letter rulings and later in regulations, the Internal Revenue Service took the position that a farmer receiving a patronage refund from a cooperative, regardless of its form, was required in computing his taxable income to take such refund into account at its face value and in the taxable year in which allocation was made where his business income was affected, which was usually the case. This position produced some controversy and litigation. On February 14, 1958, the Internal Revenue Service gave notice in Technical Information Release No. 69 that the regulations on the subject would be amended to conform them to the "principle" enunciated in two cases, *B. A. Carpenter*[47] and *Long Poultry Farms.*[48]

These decisions were considered to be contrary to the 1951 congressional intent concerning the tax treatment of patronage refunds. Congress set about to change the situation with the Revenue Act of 1962 and the later per-unit retain amendments in 1966 and 1969.[49]

Union Cooperative Exchange, 42 B. T. A. 1200 (1940); *Valparaiso Grain & Lumber Co.,* 44 B. T. A. 125 (1941). *Cf.* Rev. Rul. 54-297, 1954-2 Cum. Bull. 132. Where certain "wholesale" sales to nonmembers resulted in no profit, such sales were allowed to be excluded before profits were allocated between member and nonmember sales. *Producers Crop Improvement Association,* 7 T. C. 562 (1946).

[47]In *Commissioner* v. *B. A. Carpenter,* 219 F. 2d 635 (5th Cir. 1955), *affirming* 20 T.C. 603 (1953), the court held that patronage refunds were reportable by a "cash-basis" taxpayer member when made or allocated by the cooperative, but only at their "fair market value" if in a noncash form. If fair market value was found to be zero, the taxpayer received no present income.

[48]In *Long Poultry Farms, Inc.* v. *Commissioner,* 249 F. 2d 726 (4th Cir. 1957), *reversing* 27 T.C. 985 (1957), the court held that a patronage refund allocated to the account of a member who kept his books and recorded his income on an "accrual basis" was not a properly accruable item of income to the member in the year in which the allocation was made. In so holding, the court distinguished the case on the facts from the Tax Court's earlier rulings in *Harbor Plywood Corp.,* 14 T.C. 158 (1950), *affirmed,* 187 F. 2d 734 (9th Cir. 1951) and *George Bradshaw,* 14 T.C. 162 (1950). The court also rejected in strong language the "receipt and reinvestment" theory as applied to book credits of the type involved in this case.

Another circuit court of appeals had also ruled that patronage refunds were reportable by a "cash-basis" taxpayer only when redeemed in cash. *Caswell's Estate* v. *Commissioner,* 211 F. 2d 693 (9th Cir. 1954), *reversing* 17 T.C. 1190 (1952). See also *Moe* v. *Earle,* 226 F. 2d 583 (9th Cir. 1955), *certiorari denied,* 350 U.S. 1013 (1956).

[49]See "Subchapter T and Related Provisions of Code," p. 381.

The following discussion traces the development of this aspect of the taxation of cooperatives and their patrons. It also shows, in part at least, how the "current single tax objective" developed.

The Treasury, in 1953, had for the first time included a section on the taxability of patronage refunds to patrons in its formal tax regulations.[50] These regulations were supplemented in 1954 by Revenue Ruling 54-10.[51]

The 1954 ruling reiterated the requirements of the regulations that all patronage refunds must be reported at their face amount if made in fulfillment of a valid preexisting obligation of the association to the patron, except where the patron's business income is not affected. It said that this was merely a reaffirmation of the policy of the Service "which had been long established."[52]

The ruling pointed out that this treatment is consistent "with the theory under which patronage dividends are treated by cooperative associations"; namely," * * * that the patron by express contract or by doing business with the cooperative agrees to allow the association to retain funds to which the patron is entitled. * * * It is considered that the patron has in effect received in money the face amount of the document and has either reinvested such amount in the capital of the association or allowed the association the use of the money. * * *"

The ruling recognized the problem presented by the fact that some patrons had failed to reflect in their tax returns the entire face amount, even though the regulations required such action. It established these rules: If the period of limitations had not expired, the face amount was reportable. If the period of limitations had expired, the difference, if any, between the amount reported in the year of allocation and the amount received on redemption was reportable in the year of redemption.

Where the Service had notice that the patron had failed to report the entire face amount of an allocation received in document form after the statute of limitations had expired, the Service would not insist that the excess over the reported amount be included in the patron's income in the year of redemption, except for that part of the excess which exceeded the face amount of the document.

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[50]T.D. 6014, approved May 29, 1953, 1953-1 Cum. Bull. 110. For later form of this regulation, see 26 C.F.R. 39.22(a)-23.

[51]1954-1 Cum. Bull. 24.

[52]For a listing and discussion of prior rulings of the Treasury, see Nieman, *Multiple Contractual Aspects of Cooperatives' Bylaws,* 39 Minn. L. Rev. 135,151 (1955).

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Where an allocation was made which was not pursuant to a preexisting agreement and the document issued was not a negotiable instrument, the amount received upon redemption, sale, or other disposition of the document was to be included in gross income for the patron's taxable year in which received. It was assumed that this applied to allocations of nonpatronage income by section 521 cooperatives.

Where an allocation not pursuant to a preexisting agreement was a negotiable instrument, it was to be reported at fair market value unless the period of limitations had expired. In the latter case, the difference between the amount reported in the year of allocation and the amount later received was reportable.[53]

The first case involving the taxability of refunds in the hands of patrons was decided by the Tax Court in 1950.[54] This case held that certain "credit memoranda" issued by a manufacturing cooperative were income to an *accrual basis* taxpayer when issued rather than when redeemed. A week later, the Tax Court held that accrual basis patrons of a dealers' wholesale grocery cooperative were required to include in their income, when received and at full face value, certain subordinated, registered notes of the cooperative which were not payable until liquidation although redeemable upon call by the cooperative's board.[55]

The first *cash basis* patron case to come before the Tax Court was decided in 1951.[56] The cooperative involved in the case was also before the Tax Court in a companion case,[57] and the findings of the court in that case were incorporated in the patron's case. The court said:

> The Cooperative was under no obligation either to return the amounts to the members or to issue revolving fund certificates for the amounts it retained as a reserve from marketing operations. They belonged to and were taxable income of the Cooperative. * * * Dr. P. Phillips Cooperative voluntarily issued revolving

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[53]For a dissenting view on the treatment to be accorded refunds not made pursuant to a preexisting obligation, see Nieman, *op. cit. supra,* footnote 52, in this section, 164-166.

[54]*Harbor Plywood Corporation,* 14 T.C. 158 (1950), *affirmed,* 187 F. 2d 734 (9th Cir. 1951). For analysis of the theory of this and subsequent decisions mentioned here, see Nieman, *op. cit. supra,* footnote 52, in this section, 155 *et seq.*

[55]*George Bradshaw,* 14 T.C. 162 (1950).

[56]*P. Phillips,* 17 T.C. 1027 (1951).

[57]*Dr. P. Phillips Cooperative,* 17 T.C. 1002 (1951).

> fund certificates against the amounts retained from marketing operations. Those certificates had no fair market value and did not represent income to the recipients on that basis. * * *
>
> The situation with respect to the amounts retained by the Cooperative from its 1946 caretaking activities is different. It has been held in *Dr. P. Phillips Cooperative, supra,* that those amounts never belonged to the Cooperative. It was required by its contracts with the members to issue revolving fund certificates for the funds thus retained. The members agreed in advance that those funds, which continued to belong to them, could be retained by the Cooperative for the special purpose of the reserve.[58]

On this reasoning, the court held that Phillips was taxable in the year of issue on the face amount of the certificates issued in connection with caretaking activities but not on the certificates issued in connection with marketing operations. This case resulted in a consistent application of cooperative theory as to the status of patronage refunds both from the standpoint of the cooperative and the patron.

Other cases soon followed, however, and the situation became confused. In 1952, the Tax Court held in *Estate of Wallace Caswell*[59] that certain certificates, representing amounts retained by the association for a "commercial reserve" from the proceeds of peaches sold by the Caswell patrons, constituted income to them at the time of issue to the extent of their fair market value.

Later, the Tax Court followed this case in holding that a taxpayer realized income upon the receipt of certificates of preferred stock from his cooperative to the extent of the fair market value of such certificates, which it determined to be equal to their par value.[60]

In 1953, the Tax Court decided *B. A. Carpenter*.[61] It held that a cash-basis taxpayer need not include in gross income the face amount of revolving-fund certificates issued by a farmer cooperative at its option in lieu of cash and which were found to have no fair market value at time of issue.

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[58] *P. Phillips,* 17 T.C. 1027, 1029 (1951).

[59] 17 T.C. 1190 (1952), *reversed,* 211 F. 2d 693 (9th Cir. 1954).

[60] *William A. Joplin, Jr.,* 17 T.C. 1526 (1952).

[61] 20 T.C. 603 (1953), *affirmed,* 219 F. 2d 635 (5th Cir. 1955).

Later that year, a Federal district court in Iowa held that the plaintiff-patron was not taxable on credits in a "Reserve for General Contingencies" established by the cooperative.[62]

Although the opinion in this case refers to the patron's inability to get cash for the credits, examination of the cooperative's articles and bylaws and its directors' resolution creating the reserve indicates that it was not obligated to pay the patrons the money which was transferred to the reserve so that the issuance of credits must have been voluntary and there was nothing to indicate that they had a market value.[63]

In 1954, the Ninth Circuit Court of Appeals reversed the Tax Court's earlier decision in the *Caswell* case.[64] It held that the certificates issued by the cooperative were mere evidences of the patrons' contingent rights in the commercial reserve, which rights existed even without the issuance of the certificates. It further said that these rights were subject to the happening of certain contingencies, none of which had occurred. Accordingly, it said that the certificates did not constitute taxable income to the recipients to any extent whatever in the year of issue.

That same year the Tax Court again held that the recipient of certain "retain certificates" was taxable only on the fair market value of the certificates, and found that the certificates in question had no fair market value capable of being ascertained with reasonable certainty.[65] The court also found, however, under the bylaws there involved, that the board of directors had the power to "retain the funds whether or not they chose to issue the certificates." This suggests the absence of a prior mandatory obligation.

In an unreported oral opinion on June 30, 1954, in *Moe* v. *Earle* (Civil No. 7074), the U.S. District Court for the District of Oregon held that the taxpayer there involved realized no income "in the year in which such amounts were deducted from the sums of money payable to the plaintiffs for their fruit, or in the year in which such (revolving fund) certificates were issued to the plaintiffs," but implied that any cash subsequently received upon redemption of the certificates would be income to the taxpayer in the year of redemption. The amounts involved were specific capital

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[62] *Farmers Grain Dealers Association of Iowa* v. *United States,* 116 F. Supp. 685 (S.D. Iowa 1953).

[63] Nieman, *op. cit. supra,* footnote 52, in this section, 164.

[64] *Caswell's Estate* v. *Commissioner,* 211 F. 2d 693 (9th Cir. 1954).

[65] *Mary Grace Howey,* 13 CCH Tax Ct. Memo. 399 (1954).

retains from sales proceeds and not patronage refunds.

On March 2,1955, the U.S. Court of Appeals (Fifth Circuit) affirmed the earlier Tax Court opinion in *B. A. Carpenter.*[66]

Finally, on October 28, 1955, *Moe* v. *Earle* was affirmed by a *per curiam* opinion, and, on April 9, 1956, the Supreme Court of the United States denied certiorari.[67]

Subchapter T and Related Provisions of Code

In 1961, the President proposed the collection of a single tax currently either from cooperatives or their patrons, "assessing the patron," as his message said, on the amounts that are "allocated to him as patronage dividends or refunds in scrip or cash."

The President was specific in his recommendation that farmer cooperatives should not be penalized by assessing a patronage tax on them, if their members elect to leave their patronage allocations with their cooperatives for capital purposes.[68] In other words, it was recognized that cooperatives needed to be capitalized by their patron members—that this was the only feasible way for them to do it— and all that was asked for in the tax laws was that there be a single tax collected currently. The 1961 legislative proposals that became subchapter T in 1962, were backed up by recommendations that took into account the distinctive characteristics of cooperatives.

The Internal Revenue Code now contains detailed provisions on the taxation of cooperatives and their patrons. The pertinent provisions are section 521 and subchapter T (sections 1381-3, 1385, and 1388).

Those farmer cooperatives qualifying under section 521 of the Code, while subject to income tax, are generally in position to operate with little or no taxable income. This does not mean that income escapes taxation. The cooperative will end up with little or no taxable income only to the extent that the patrons include the amounts involved in their taxable income.[69]

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[66] *Commissioner* v. *B. A. Carpenter,* 219 F. 2d 635 (5th Cir. 1955).

[67] *Moe* v. *Earle,* 226 F. 2d 583 (9th Cir. 1955), *cert. den.,* 350 U.S. 1013 (1956).

[68] H.R. Doc. No. 140 (vol. 1), 87th Cong., 1st sess. 14 (1961), Hearings on President's 1961 Tax Recommendations before the Committee on Ways and Means.

[69] See "Taxation of Cooperatives and Patrons Under Subchapter T," p. 426.

Farmer cooperatives that do not qualify as section 521 cooperatives are liable for income tax on amounts devoted to the payment of a return on capital and on amounts which they do not return to patrons as patronage refunds in the manner prescribed by the Code.

As noted previously,[70] Congress had sought to tax "income" generated through cooperative activity at least once—either to the cooperative, if unallocated, or to the patrons, if allocated to them. The 1951 Act removed the exemption for farmer cooperatives (although still referring to them as "exempt") and provided that in addition to all other deductions permitted corporations generally, those cooperatives meeting the requirements of section 521 would have the two deductions specified in section 522. Patronage refunds were also made nontaxable to cooperatives by the 1951 legislation, if allocated to patrons pursuant to a prior mandatory obligation—the courts and Treasury rulings already having established this right on the part of cooperatives.

The 1951 effort to impose a single tax currently at either the cooperative or patron level was not successful. Questions arose concerning the income tax liability of patrons.[71] The courts, while approving the right of cooperatives to exclude from taxable income the full amount of properly authorized patronage refunds, would not allow tax collections at the patron level on the stated dollar amount of noncash patronage refunds.

The courts had concluded that allocations of noncash patronage refunds (to the extent they reflected business activity) were currently taxable to the patron only to the extent of their "fair market value," even though they were deductible in full by the cooperative. Arguments that many patrons were regularly including the full amount of their refunds in taxable income, as required by Treasury, and that separate and distinct taxpayers were involved—the cooperative on the one hand and the patron on the other—were of no avail. Legislative clarification was sought. The Revenue Act of 1962[72] was enacted.

The 1962 Act repealed section 522, which in 1951 had subjected "exempt" farmers' cooperatives to income tax, and added a

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[70]See "Taxation on 'Exempt' Cooperatives Under the 1951 Act," p. 363.

[71]See "Taxability of Patronage Refunds to Patrons—Pre-1962 Treatment," p. 376.

[72]76 Stat. 1045-51.

new subchapter T (sections 1381-3, 1385 and 1388) to the Internal Revenue Code of 1954.

Subchapter T,[73] headed "Cooperatives and Their Patrons," is divided into these three parts:

Part I —Tax Treatment by Cooperatives;
Part II —Tax Treatment by Patrons of Patronage Dividends and Per-Unit Retain Allocations; and
Part III—Definitions; Special Rules.

Subchapter T applies, in general, to "any corporation operating on a cooperative basis," with certain exceptions specified in section 1381(a)(2).

Section 521 of the Code, while not a part of subchapter T, bears directly on the tax treatment of farmer cooperatives. Of course, a farmer cooperative is not required to qualify under section 521. If it does, though, in computing its taxable income under subchapter T it may use, in addition to all other deductions authorized by law, the deductions provided under section 1382(c) of the Code.

These additional deductions, like those under the repealed section 522, relate to amounts paid during the taxable year as dividends on capital stock and certain nonpatronage income allocated to patrons such as rents received, investment income, gain on sale of capital assets, and income from business done with or for the U.S. Government.

About 65 percent of the farmer cooperatives filing returns for the taxable year 1963 operated in compliance with the terms of section 521.[74] Later unofficial statistics indicate an increase in the percentage of section 521 cooperatives to almost 70 percent of the farmer cooperatives filing returns.[75] Whether section 521 status is advisable for every cooperative where qualification is possible is a

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[73]76 Stat. 1045-51, as amended in 1966 by Pub. L. 89-809, 80 Stat. 1580.

[74]Statistics of Income—1963, Supplemental Report, Farmers' Cooperative Income Tax Returns 1 (U.S. Treas. Dept. Int. Rev. Ser. Pub. No. 386, 1966).

[75]Harmanson, Jr., *The Cooperative Tax Picture,* Cooperative Accountant, Winter 1968, 4 at p. 5; and Harmanson's report to the Annual Meeting of the National Council of Farmer Cooperatives, Washington, D.C., January 1969. Indications are that this percentage may decrease as the new "look through" principle is applied to federated cooperatives. See "Federated Cooperatives," p. 422; and Griffin, *A Financial Profile of Farmer Cooperatives in the United States,* FCS Res. Rpt. 23, Farmer Cooperative Service, U.S. Dept. Agr. (1972), p.65.

frequently debated question. Those wishing to pursue the subject will find that the pros and cons have been treated extensively.[76]

Requirements for 521 Status

Section 521 of the Internal Revenue Code of 1954 provides as follows:

§521. Exemption of Farmers' Cooperatives from Tax.

(a) *Exemption from tax.*

A farmers' cooperative organization described in subsection (b) (1) shall be exempt from taxation under this subtitle except as otherwise provided in part I of subchapter T (sec. 1381 and following). Notwithstanding part I of subchapter T (sec. 1381 and following), such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

(b) *Applicable rules.*

(1) *Exempt farmers' cooperatives.*

The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing

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[76]See, *e.g.,* Guenzel, *So-Called "Exempt" Cooperatives,* American Cooperation—1970, 64; Magnuson, *All Farmer Cooperatives And Other Corporations Operating On A Cooperative Basis,* American Cooperation—1970, 69; McCullough, *Cooperatives, Exempt or Non-Exempt—A 1970 Revisitation,* Cooperative Accountant, Fall 1970, 2; McCullough, *Cooperatives, Exempt or Nonexempt,* American Cooperation—1968, 147; Olmsted, *The Case for Nonexempt Status,* Statement presented at 39th Annual Meeting, National Council of Farmer Cooperatives, January 1968; Marrs, *Exempt Cooperatives—Why,* American Cooperation—1968, 522; Nieman, *"Exempt," To Be Or Not To Be—The Case For,* Cooperative Accountant, Winter 1962, 13; Olmsted, *Cooperatives Should be Nonexempt,* Cooperative Accountant, Winter 1962, 19.

supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) *Organizations having capital stock.*

Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) *Organizations maintaining reserve.*

Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) *Transactions with nonmembers.*

Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(5) *Business for the United States.*

Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

It is misleading to call cooperatives that qualify under section 521 "tax exempt." The law in fact provides no income tax exemption for them. Unless this is understood, confusion will continue concerning the tax status of farmer cooperatives.

Unfortunately, the statute uses the heading "Exemption of farmers' cooperatives from tax" and otherwise refers to them as organizations "exempt from income taxes" while it subjects them to income tax under subchapter T. It is not surprising therefore that much of the material on section 521 cooperatives and the regulations themselves speak in terms of "exempt farmers' cooperatives" or "qualifying for exemption." But it seems a bit unrealistic to label as "tax exempt," cooperatives that pay substantial amounts annually in income taxes.[77]

A cooperative that qualifies under section 521 is referred to herein as a "section 521 cooperative" or one with "521 status" rather than a tax exempt organization. Occasionally, however, the words "tax exempt" and "exemption" will be found in quoted material or the text where it seems necessary to explain the holding of a revenue ruling or court decision.

If a cooperative can meet the requirements specified in section 521, it can qualify for the tax treatment provided in part I of subchapter T. The chief requirements for such qualification have been summarized as follows:[78]

1. It must be a farmer, fruit grower, or like association organized and operated on a cooperative basis to (a) market the products of members and other producers, or (b) purchase supplies and equipment for the use of members or other persons.

2. If organized on a capital stock basis, substantially all its stock (other than preferred nonvoting stock) must be owned by producers marketing products or purchasing supplies through it.

3. The dividend rate on capital shares must not exceed the legal rate of interest in the State of incorporation, or 8 percent a year, whichever is the greater, based upon the value of the consideration for which the capital shares were issued.

4. Financial reserves are restricted to those required by State laws or those that are reasonable and necessary, and must be

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[77]See, *e.g.,* Announcement 67-2, I.R.B. 1967-3, 21 (based on News Release IR-854, dated Dec. 15, 1966), reporting with respect to farmers' cooperative income tax returns that "exempt cooperatives paid $2 million in taxes for 1963, nonexempt cooperatives paid $13 million."

[78]*Farmer Cooperatives in the United States,* FCS Bull. No. 1, p. 19, Farmer Cooperative Service, U.S. Dept. Agr., (1965).

allocated to patrons unless the cooperative includes them in computing taxable income.

5. Business with nonmembers may not exceed 50 percent of the cooperative's total business, and purchasing for persons who are neither members nor producers may not exceed 15 percent of the cooperative's total purchasing.

6. Nonmembers are to be treated the same as members in such business transactions as pricing, pooling, or payment of sales proceeds, in prices of supplies and equipment, in fees charged for services, or in the allocation of patronage refunds to the accounts of patrons.

7. Permanent records of the patronage and equity interest of all members and nonmembers must be maintained.

8. The legal structure of the organization must be cooperative in character and contain no provisions inconsistent with these requirements, and the association must be actually operated in the manner and for the purposes outlined in the requirements.

These eight requirements are discussed in more detail beginning on page 392.

Application for 521 Status and Tax Returns

In order to establish its section 521 status, every organization claiming that it qualifies must file a Treasury Department Form 1028. The Form 1028 should be executed in accordance with the instructions and filed with the District Director for the internal revenue district in which is located the principal place of business or principal office of the organization. Section 521 status is not automatic.[79]

A ruling or determination letter will be issued in advance of operations of a farmer cooperative, provided it is shown that the cooperative is organized and will be operated for the purposes stated in section 521.[80]

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[79]Treas. Reg. § 1.521-1(a)(3)(e); Rev. Proc. 72-4, 1972-1 Cum. Bull. 706, and as to federated cooperatives, see also Rev. Proc. 72-16, 1972-1 Cum. Bull. 738, and Rev. Proc. 72-17, 1972-1 Cum. Bull. 739. See Announcement 70-13, I.R.B. 1970-5, 63, based on News Release IR-1010, dated January 29,1970, outlining a centralized procedure established by the Service for processing applications for "exemption," including 521 cooperatives, and for thorough audits of exempt organizations.

[80]Rev. Proc. 72-4, 1972-1 Cum. Bull. 706.

The proposed operations must be described in sufficient detail to permit a conclusion that the cooperative clearly qualifies. A mere statement of a cooperative's purposes or a statement that proposed activities will be in furtherance of such purposes is not sufficient to satisfy the requirements for an advance ruling.

Complete evidence for each year for which qualification is sought should be furnished. For example, if a cooperative furnishes information and financial statements relating to one fiscal year, qualification, if in order, would be approved for that fiscal year and subsequent years. If, on the other hand, a cooperative furnishes the necessary information and statements for several prior years, qualification, if in order, would be recognized for the years for which complete evidence of qualification was furnished and subsequent years.

Cooperatives meeting the requirements of section 521 must file income tax returns, Form 990-C, on or before the 15th day of the 9th month following the close of their taxable year. The filing of Form 990-C appears to start the period of limitation under chapter 66 of the Code.

Farmer cooperatives not having 521 status file the usual corporation income tax returns (Form 1120). The due date of the Form 1120 return for such a cooperative is also the 15th day of the 9th month following the close of the fiscal year if the cooperative either (1) is under an obligation to pay patronage refunds of at least 50 percent of its "net earnings" from business done with or for its patrons, or (2) has actually paid patronage refunds in that percentage for the most recent taxable year it had such "net earnings."[81] If a cooperative does not meet these standards, the due date of its income tax return (Form 1120) is the 15th day of the 3rd month following the close of the fiscal year.

Information Returns Required

The Revenue Act of 1962 requires certain tax information reporting by farmer cooperatives. Under this Act, all subchapter T cooperatives must file annual information returns on Forms 1096 and 1099 with the Internal Revenue Service reporting payments of interest, dividends, qualified written notices of allocation

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[81]Int. Rev. Code of 1954, § 6072(d)(2).

(patronage refunds), and redemption of nonqualified written notices of allocation of $10 or more a year to any one person.[82]

The 1966 per-unit retain amendments require a cooperative to include in these annual returns the face amount of qualified per-unit retain certificates issued, as well as amounts paid in redemption of nonqualified certificates of $10 or more to any one person. Cooperatives also must send a statement to the recipient showing the amount reported to the Internal Revenue Service.

There is an exemption from some of these reporting requirements. If a cooperative is primarily engaged in retail selling of goods and services that are generally for nonbusiness use (personal, living, or family use), it may apply to the Secretary of the Treasury or his delegate for an exemption from the information reporting requirement.[83]

Audits and Revocation of Status

Once a ruling or determination letter is obtained, it is not necessary to refile for qualification unless substantial changes are made in the organization or its activities. An association is required, however, to furnish information annually on Treasury Form 990-C, which relates to its section 521 status.

The Internal Revenue Service is not precluded from making an investigation of such an organization to determine its eligibility or the amount of its tax liability.[84]

Qualification continues only so long as the legal setup and the operating methods are in accord with the requirements of the applicable statutes and regulations.[85] Thus, a change in status can occur even though the letter of determination is not withdrawn, canceled, or revoked by the Internal Revenue Service.

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[82]Int. Rev. Code of 1954, § 6044 and the regulations thereunder. See also Rev. Rul. 68-236, 1968-1 Cum. Bull. 382.

[83]Int. Rev. Code of 1954, § 6044(c).

[84]*United States* v. *Stiles,* 56 F. Supp. 831 (W.D. Ark. 1944); *Union Equity Cooperative Exchange,* 58 T.C. 397 (1972). See also Announcement 70-13, I.R.B. 1970-5, 63, relating to audits, cited at footnote 79 in this section.

[85]See Rev. Proc. 72-4, 1972-1 Cum. Bull. 706, for discussion of procedure in case of revocation or modification of determination letters and protests of adverse determinations. As to federated cooperatives, see also Rev. Proc. 72-16, 1972-1 Cum. Bull. 738, and Rev. Proc. 72-17, 1972-1 Cum. Bull. 739, relating to information from members and acceptable methods necessary to establish that operations satisfy the "look through" principle. See "Federated Cooperatives," p. 422.

In an early case it was held that if an association has been erroneously granted exemption, this ruling is not binding on subsequent Commissioners of Internal Revenue who may set the so-called exemption aside and then proceed to collect income taxes for the entire period in question.[86] In the case cited, as no income tax returns had been filed, the statute of limitations had not run.

It has also been held that the filing of Form 990[87] would not start the running of the statute, because it was not a tax return and did not supply adequate information from which the amount of tax, if any, could be determined.[88] On the other hand, Form 990-C, which is the tax return section 521 farmer cooperatives must now file, would, however, be sufficient,[89] and the filing of this form would start the running of the statute.[90]

Not only may an "exemption" which has been improperly allowed be set aside and the association be held liable for income taxes, but if the Service erroneously makes a refund to an association such refund may be recovered by the Government.[91]

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[86]*Southern Maryland Agricultural Fair Association,* 40 B.T.A. 549 (1939). See *Lorain Avenue Clinic,* 31 T.C. 141, 163 (1958); *Southern Hardware Traffic Association* v. *United States,* 411 F. 2d 563 (6th Cir. 1969), *affirming* 283 F. Supp. 1013 (W.D. Tenn. 1968), where the Commissioner was not estopped to correct a mistake of law and he was held not to have abused his discretion in revoking an exemption retroactively. See also *Etter Grain Co.* v. *United States,* 462 F. 2d 259 (5th Cir. 1972), *affirming* 331 F. Supp. 283 (N.D. Tex. 1971); *Union Equity Cooperative Exchange,* 58 T.C. 397 (1972).

[87]The information return required to be filed by certain "exempt" organizations after 1943.

[88]*Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180 (1957).

[89]In this connection, note that section 6501(g)(2) of the Internal Revenue Code provides that "If a taxpayer determines in good faith that it is an exempt organization and files a return as such under section 6033, and if such taxpayer is thereafter held to be a taxable organization for the taxable year for which the return is filed, such return shall be deemed the return of the organization for purposes of this section." *California Thoroughbred Breeders Association,* 47 T.C. 335 (1966), holds that filing an information return (Form 990) constitutes the return for the purpose of the 3-year period of limitations against assessment of tax on unrelated business income imposed by section 511 of the Code. The Commissioner acquiesced in the result only (1969-1 Cum. Bull. 21), meaning acceptance of the decision of the court but disagreement with some or all the reasons assigned for the decision. See Rev. Rul. 69-247, 1969-1 Cum. Bull. 303. See also *Colombo Club, Inc.,* 54 T.C. 100 (1970), holding that there was no abuse of discretion in retroactively revoking an exemption and that an application for exemption with supporting papers did not constitute the filing of a return within the meaning of section 6501(g)(2).

[90]For applicable statute, see Int. Rev. Code of 1954, § 6501-6533.

[91]*Producers Creamery Co.* v. *United States,* 55 F. 2d 104 (5th Cir. 1932).

For an organization that was exempt from the tax but subsequently became taxable, it was necessary, in computing the gain or loss from the sale or exchange of property, to reduce the basis by the amount of depreciation sustained with respect to the property for the period it was held while the taxpayer was exempt, as well as subsequently.[92]

Under the established practice of the Internal Revenue Service, exemption comes to an end on the day a cooperative ceases operations. Accordingly, even prior to December 31, 1951, if gains were realized on the sale of assets after the association had ceased to operate, the cooperative was required to file an income tax return and pay a tax if one was due.

General

If an association is not organized so as to meet the requirements for 521 status, it is ineligible therefor. "It is elementary," said the Board of Tax Appeals,[93] "that if the petitioner may successfully claim that it is exempt from income tax under the * * * law it must be because it fills all of the requirements of the statute * * * ." The Board went on to say:

> The undisputed proof in this case shows that at least 30 percent of the profit realized by the petitioner from the operation of its elevator department was from non-stockholders to whom it did not and could not turn back anything other than the original price paid them for their grain, which was the market price. * * *
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> * * * The petitioner's case is not strengthened by the fact that up to the end of the year 1928 it had not paid any patronage dividends with the exception of certain patronage dividends in the form of shares of stock upon the business of 1918. The simple fact is that the petitioner was not in 1928 organized to come within the exempting provisions of the statute.

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[92]G.C.M. 27491, 1952-2 Cum. Bull. 221. Since this ruling revoked G.C.M. 10857, XI-2 Cum. Bull. 105 (1932), which held to the contrary, it applies only to sales occurring in taxable years beginning after December 31, 1950.

[93]*Farmers Union Cooperative Co.*, 33 B.T.A. 225, at 228 (1935), *affirmed*, 90 F. 2d 488 (8th Cir. 1937). See also *Council Bluffs Grape Growers Association*, 44 B.T.A. 152 (1941).

The eight requirements for section 521 status previously summarized are discussed in more detail in the following paragraphs.

Section 521 status is available only to organizations of "farmers', fruit growers', or like associations." They must be organized and operated on a cooperative basis.[94] Both marketing associations and purchasing associations may qualify. If a marketing organization,[95] it must be for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them. If a purchasing organization,[96] it must be for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

An association engaged in both marketing farm products and in purchasing supplies and equipment may qualify under section 521 if, as to each of its functions, it meets the requirements of the Code.[97]

The courts have held that the term "like associations" in section 521(b)(1), by reason of its association with the words "farmers' " and "fruit growers'," is limited by them and refers only to associations of farmers or others engaged in like occupations.[98]

The Internal Revenue Service takes the position that for a cooperative to qualify, it must be an association which markets agricultural products or purchases supplies and equipment for persons engaged in producing agricultural products.[99] Associations composed of other than agricultural producers would not qualify.

The inclusion of a substantial number of nonproducers in an otherwise qualified cooperative would also destroy the 521 status

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[94]Int. Rev. Code of 1954, § 521(b)(1).

[95]Int. Rev. Code of 1954, § 521(b)(1)(A).

[96]Int. Rev. Code of 1954, § 521(b)(1)(B).

[97]Treas. Reg. § 1.521-1(c). Rev. Rul. 67-253, 1967-2 Cum. Bull. 214, holds that a marketing and purchasing association did not qualify where it had not established net savings of either of its departments, had not kept records of business done with its marketing patrons, and had not allocated any patronage refunds to its marketing patrons.

[98]*Sunset Scavenger Company, Inc.* v. *Commissioner*, 84 F. 2d 453 (9th Cir. 1936); *Garden Homes Co.*, 26 B.T.A. 441, 462 (1932), *reversed on other grounds*, 64 F. 2d 593 (7th Cir. 1933).

[99]G.C.M. 8619, X-1 Cum. Bull. 150 (1931).

of the cooperative on the ground that it ceases to be a *farmers'* association.[100]

Producers of grain, fruit, nuts, vegetables, tobacco, poultry and eggs, as well as dairymen and livestock ranchers, have formed cooperatives eligible under section 521.[101] On the other hand, harbor boat pilots, garbage collectors, advertising agents, apartment owners, or persons buying for resale to the general public have not been able to form associations that qualify.[102]

Identifying those organizations that are "like" associations of farmers is not always easy.[103] The Internal Revenue Service, applying the principle of *ejusdem generis,* declared that a purchasing cooperative of fishermen and oyster growers would not qualify under section 521, even though State laws include fish and seafood within the term "agricultural products."[104] A later ruling, however, holds that a cooperative to market fish raised by its members in privately owned waters can qualify because the fish are "farm-raised" crops and hence farm products.[105]

A cooperative that owned bulls and provided artificial breeding service to the cattle of its members has been held qualified.[106] The cooperative's activities constituted the furnishing of farm supplies to its members since the product furnished enabled them to produce livestock. But a cooperative whose *only* activities con-

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[100] *Co-operative Central Exchange*, 27 B.T.A. 17 (1932). See also discussion under "Capital Stock" in this section, p. 400.

[101] Treas. Reg. § 1.521-1(a)(1). See also *Producers' Produce Co.* v. *Crooks,* 2 F. Supp. 969 (W.D. Mo. 1932) (poultry and eggs); *Eugene Fruit Growers Association,* 37 B.T.A. 933 (1938) (fruits, vegetables, and nuts); *Sumner Rhubarb Growers' Association,* 10 CCH Tax Ct. Memo. 465 (1951) (vegetables); *Long Poultry Farms, Inc.* v. *Commissioner,* 249 F. 2d 726 (4th Cir. 1957) (poultry). *Cf.* Rev. Rul. 57-358, 1957-1 Cum. Bull. 42 (tobacco).

[102] *Mobile Bar Pilots Association,* 35 B.T.A. 12 (1936), *rev'd on other grounds,* 97 F. 2d 695 (5th Cir. 1938) (harbor boat pilots); *Sunset Scavenger Company, Inc.* v. *Commissioner,* 84 F. 2d 453 (9th Cir. 1936)(garbage collectors); *National Outdoor Advertising Bureau, Inc.* v. *Helvering,* 89 F. 2d 878 (2d Cir. 1937) (advertising); *Garden Homes Co.* v. *Commissioner,* 64 F. 2d 593 (7th Cir. 1933) (cooperative apartment); *Northwestern Drug Co.,* 14 B.T.A. 222 (1928) (sale of drugs); G.C.M. 8619, X-1 Cum. Bull. 150 (1931) (marketing building materials). See also *Etter Grain Co.* v. *United States,* 462 F. 2d 259 (5th Cir. 1972), *affirming* 331 F. Supp. 283 (N.D. Tex. 1971).

[103] See Logan, *Federal Income Taxation of Farmers' and Other Cooperatives,* 44 Texas L. Rev. 250 at 252-257 (1965).

[104] Rev. Rul. 55-611, 1955-2 Cum. Bull. 270.

[105] Rev. Rul. 64-246, 1964-2 Cum. Bull. 154.

[106] Rev. Rul. 68-76, 1968-1 Cum. Bull. 285.

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sisted of caring for and maintaining its patrons' citrus groves and harvesting their crops did not qualify.[107] This ruling recognizes that grove caretaking and harvesting are farming activities, but states that they do not involve the sale or the processing for sale of agricultural products. These activities, according to the ruling, do not constitute "marketing" within the meaning of the statute nor the purchase of supplies and equipment which the regulations[108] define to include "groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmers' household."

A cooperative which acquires the beneficial use of land and apportions it among its members for grazing their livestock qualifies under section 521.[109]

The scope of permissible activity by a section 521 cooperative is quite broad. Associations have been allowed to manufacture their products, to change the form of raw materials, and in some instances to operate subsidiaries, so long as the operations are not on an ordinary profitmaking basis.[110]

A dairy cooperative can make butter, cheese, and other dairy products.[111] A livestock marketing association may slaughter animals and process the meat.[112] A marketplace may be operated by a cooperative,[113] and it may collect, store, sort, grade, and pro-

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[107]Rev. Rul. 66-108, 1966-1 Cum. Bull. 154. See *Dr. P. Phillips Cooperative*, 17 T.C. 1002 at 1009-1010 (1951).

[108]Treas. Reg. § 1.521-1(b).

[109]Rev. Rul. 67-429, 1967-1 Cum. Bull. 218.

[110]S. Rep. No. 52, 69th Cong., 1st sess. 24 (1926); H.R. Rep. No. 356, 69th Cong., 1st sess. 36-37 (1926). With respect to subsidiaries, Rev. Rul. 69-575, 1969-2 Cum. Bull. 134, holds that a 521 cooperative will lose its status if a subsidiary of the cooperative handling nonmember-nonproducer business fails to make patronage refunds to nonmembers or violates the 15 percent limitation on nonmember-nonproducer business. In other words, a 521 cooperative may not, through a subsidiary, carry on functions or methods of operation not permitted in its own operations. *Accord*, Rev. Rul, 73-148, 1973 Cum. Bull. 294.

[111]Treas. Reg. § 1.521-1(a)(1); *Anamosa Farmers Creamery Co*, 13 B.T.A. 907 (1928), *acq.*, VIII-1 Cum. Bull. 2 (1929).

[112]I.T. 1914, III-1 Cum. Bull. 287 (1924).

[113]Rev. Rul. 67-430, 1967-2 Cum. Bull. 220, restates existing law under the current law and regulations and the position set forth in I.T. 2720, XII-2 Cum. Bull. 71 (1933). The cooperative furnishes market facilities where its farmer members assemble, display, advertise, and sell their fruits, vegetables, and other farm products. The ruling holds that the term "marketing" as used in section 521 not only includes the sale of farm products by a cooperative but *other activities* necessary to the sale of products. "Marketing" is broad enough to include "all

cess fruits and vegetables, cottonseed, and soybeans.[114] And it may own and operate canneries.[115] In operating a cannery, a cooperative would seem to be providing "supplies and equipment" for its members and others whom it is organized to serve.

In some cases, a cooperative may perform both a marketing and a supply function and, as long as it meets the tests of the statute as to each activity, it would qualify under section 521.[116] Many cooperatives so operate for the benefit of their members.

Purchasing or supply activities frequently pose questions of meeting a condition of section 521 qualification found in the regulations that a cooperative shall not engage in "occupations dissimilar from those of farmers, fruitgrowers, and the like."[117]

A fruitgrowers' exchange organized a corporation to buy the basic ingredients for fertilizer and manufacture the finished product in plants it owned. This corporation then acquired large tracts of timber together with mills to fabricate crates which it sold to the members of the parent organization. All of this was held to be a permissible activity. The ruling concludes that the corporation was merely fulfilling the responsibility of a purchasing or supply cooperative in providing supplies and equipment at the lowest possible cost to the fruitgrowers.[118]

A petroleum refinery has been owned and operated by a subsidiary of a qualified section 521 cooperative.[119] The refinery pro-

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activities which are an integral part of the marketing function." In Rev. Rul. 71-100, 1971-1 Cum. Bull. 159, a grain cooperative leased certain of its marketing facilities to an elevator operator as a means of obtaining better prices for its members' grain and did in fact allocate the net proceeds from the rental income on a patronage basis to its members. The lease arrangement was said to result in the cooperative relinquishing its authority to negotiate the prices paid to its members for their products. The cooperative was held to be engaged in a rental operation and not in the marketing of the products of its members or other producers as contemplated by section 521.

[114]See, *e.g., William A. Joplin, Jr.,* 17 T.C. 1526 (1952), *acq.,* 1954-2 Cum. Bull. 4; *Everett G. Maley,* 17 T.C. 260 (1951), *nonacq.,* 1952-1 Cum. Bull. 6.

[115]*Eugene Fruit Growers Association,* 37 B.T.A. 993 (1938).

[116]*South Carolina Produce Association* v. *Commissioner,* 50 F. 2d 742 (4th Cir. 1931). See also footnote 97 in this section.

[117]Treas. Reg. § 1.521-1(d).

[118]S.M. 2288, III-2 Cum. Bull. 233 (1924), declared obsolete but not revoked or superseded by Rev. Rul. 70-319, 1970-1 Cum. Bull. 284. See discussion at footnotes 134 and 135, this section.

[119]Rev. Rul. 54-12, 1954-1 Cum. Bull. 93, but this ruling has been reversed in part by Rev. Rul. 69-417, 1969-2 Cum. Bull. 132, discussed in text at footnote 164 in this section. See also Rev. Rul. 67-346, 1967-2 Cum. Bull. 216, holding that

duced heavy fuel oils, distillates, and other byproducts not usable by farmer patrons which were sold to railroads, steel mills, and others who did not get patronage refunds. Exchange arrangements were made with other refineries to have refinery products delivered to farmer patrons from stocks located most convenient to them. These activities were approved since they effected savings to the farmer members of the controlling association.

In another case,[120] the association sold ice and ice cream because it had found it necessary to the refrigeration of the association's products to purchase an ice and ice cream factory located on property adjoining the cannery it operated. The continuation of the ice and ice cream business reduced the refrigeration costs that would otherwise have been chargeable to the fruit marketing pools. Also, to utilize more effectively a machine shop it ran as a necessary adjunct of a cannery, some custom work was done there on a commercial basis. None of the persons who purchased ice or ice cream or who patronized the machine shop shared in patronage refunds. Passing on this phase of the cooperative's activities, the Board of Tax Appeals said at page 1001:

> Looked upon as a whole it seems to us that these "commercial departments" were purely incidental to petitioner's principal purpose. They were conducted, not for their own sake, but as an adjunct and supplement to the cooperative marketing of farm products. See *Producers' Produce Co.* v. *Crooks,* 2 F. Supp. 969. This seems to us to be the test, and not the numerical percentage of petitioner's business attributable to those branches. It may be that the proportion of business done could be so great that it would be unreal to consider such operations incidental. *Cf., Hills Mercantile Co.,* 22 B.T.A. 114. On this point we need express no opinion, since in our view no such contention could prevail on the facts before us. The principle we have stated has been applied in construing other subsection of section 103 and similar pro-

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exchanges of *unlike* products processed by nonmember-nonproducers could not be disregarded in determining the 15 percent nonmember-nonproducer limitation of section 521(b)(4) of the Code. Rev. Rul. 54-12 is distinguished on the ground that it involved an exchange of *like* products to effect transportation cost savings. See text at footnote 165, in this section.

[120] *Eugene Fruit Growers Association,* 37 B.T.A. 993 (1938).

visions, and we see no reason to reach a different result here. *Santee Club* v. *White,* 87 Fed. (2d) 5; *King County Insurance Association,* 37 B.T.A. 288; *Trinidad* v. *Sagrada Orden de Predicadores,* 263 U.S. 578; *Unity School of Christianty, supra; Sand Springs Home,* 6 B.T.A. 198. And it is to be noted that there is no statutory requirement that petitioner be engaged "exclusively" in cooperative marketing, as there was in some of the provisions construed by those decisions, but merely that it be "organized and operated on a cooperative basis (a) for the purpose of marketing the products of members * * *." We believe petitioner falls clearly within that definition.

A section 521 cooperative sold to nonmembers who received no patronage refunds. In revoking its 521 status, no challenge was made to the right of the cooperative to buy timber or plants to make box shook or other products used by producers.[121]

In other cases, cooperatives operating grain elevators, feed and general merchandising stores, machinery supply and repair shops, gasoline service stations, and the like, have lost their section 521 status, but the scope of their activities was not questioned—521 status being denied for other reasons.[122] These cases do not, of course, represent authority for a cooperative to engage in the activity involved. But, to repeat, the scope of the activity was not questioned.

Caution has been suggested[123] in relying on *Eugene Fruit Growers Association,*[124] discussed above, as a basis for measuring the scope of permissible activity. The holding is thought not to justify extensive commercial operations by a section 521 coopera-

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[121] *Fruit Growers' Supply Co.* v. *Commissioner,* 56 F. 2d 90 (9th Cir. 1932); *cf. Texsun Supply Corp.,* 17 T.C. 433 (1951).

[122] See, *e.g., Farmers Union Cooperative Co.* v. *Commissioner,* 90 F. 2d 488 (8th Cir. 1937); *Farmers Cooperative Co.* v. *United States,* 23 F. Supp. 123 (Ct. Cl. 1938); *Farmers Union Cooperative Supply Co.* v. *United States,* 23 F. Supp. 128 (Ct. Cl. 1938); *Farmers Union Cooperative Oil Co.,* 38 B.T.A. 64 (1938); *Farmers Union Cooperative Co.,* 33 B.T.A. 225 (1935); *Hills Mercantile Co.,* 22 B.T.A. 114 (1931); *cf. Cooperative Oil Association* v. *Commissioner,* 115 F. 2d 666 (9th Cir. 1941).

[123] Kerner, *Income Tax and Cooperatives,* California Farm and Ranch Law 447 at 457 (1967). See also Logan, *Federal Income Taxation of Farmers' and Other Cooperatives,* 44 Texas L. Rev. 250 at 251-257 (1965).

[124] 37 B.T.A. 993 (1938), discussed at footnote 120, in this section.

tive. In that case, the court found that substantial noncooperative, commercial activities were not such a departure from the basic or primary cooperative function as to cause a loss of status.

While the courts seem to have displayed no great tendency to apply restrictive tests in judging the activities of farmer cooperatives, there is a discernible leaning in the direction of a stricter construction of the statute in recent revenue rulings and procedures. The "look through" ruling affecting federated cooperatives discussed on page 422, and the recent ruling on byproduct sales are examples.[125]

Members and Producers

A number of questions under section 521 involve a determination of who is a "member." The regulations[126] provide that anyone "who shares in the profits of a farmers' cooperative" and is entitled to "participate in the management" of the cooperative "must be regarded as a member." In a cooperative organized as a stock corporation, membership would ordinarily be acquired through ownership of at least one share of voting stock. In one case,[127] it was held that persons not entitled to participate in the management of the association could not be regarded as members.

Also important are questions involving the "producer" status of certain persons. Revenue Ruling 67-422[128] sets forth circumstances under which a person may be considered a producer for purposes of section 521. In general, a person is a producer if, as owner or tenant, he bears the risks of production, cultivates, operates, or manages a farm for gain or profit—in short, if he is engaged in the trade or business of farming. A person who receives a rental (either in cash or in kind) which is based upon farm production is also a producer.

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[125]Rev. Rul. 69-651, 1969-2 Cum. Bull. 135; Rev. Rul. 69-417, 1969-2 Cum. Bull 132. See also H. R. Rep. 91-782, 91st Cong., 1st sess. 323 (1969), where the following appears: "The conference noted that the Treasury Department and congressional staffs had been requested by the Committee on Finance to study problems in the tax treatment of cooperatives, particularly as to whether cooperatives engage in activities which are unrelated to the purpose for which special tax treatment is given and that a report had been requested on this subject. The conferees requested that this report be made by January 1, 1972." See footnote 6, in this section.

[126]Treas. Reg. § 1.521-1(a)(3).

[127]*Producers Livestock Marketing Association of Salt Lake City,* 45 B.T.A. 325 (1941).

[128]1967-2 Cum. Bull. 217.

Generally, a person who receives a fixed rental or other fixed compensation (without reference to production) is not a producer. The ruling sets forth the following examples of circumstances in which the Service has considered the producer status of a person:

(1) A landowner leases his land to a tenant farmer for a specified number of years. Under the terms of the lease agreement the tenant farmer agrees to farm the land and pay the landowner a rental based on a certain fixed percentage of the farm crops produced. The tenant farmer has the option of paying the landowner in farm crops or their equivalent value in cash. Both the landowner and the tenant farmer qualify as producers.

(2) A stockbroker owns pasture land which he rents to a dairy farmer who uses the land to graze his dairy cattle. The dairy farmer pays the stockbroker a periodic fixed rental fee. The rental activity by the stockbroker does not qualify him as a producer.

(3) An insurance agent is engaged in the business of raising and selling chickens on a part-time basis. He qualifies as a producer.

(4) A physician, actively engaged in carrying on a medical practice, is also engaged in the business of operating a dairy farm through a manager. The manager is paid a fixed salary and has authority to make most managerial decisions for his principal. The physician qualifies as a producer. The manager's employment does not qualify him as a producer.

(5) The facts are the same as example (4) except that the manager and the physician entered into a partnership arrangement for the operation of the farm pursuant to which the manager receives a percentage of the net profit of the farm rather than a salary. Both the manager and the physician qualify as producers.

(6) A profitmaking corporation which manufactures fertilizer also maintains land devoted to raising farm products for sale at a profit. The corporation qualifies as a producer.

If a person acquires a growing crop, a sufficient period of time must elapse between the purchase and harvest to evidence the taking of the risks and responsibilities of the owner of growing crops as opposed to taking only the risks of market value at time of harvest.[129] Only then is he considered a producer by the Service.

It has been held that where a feed dealer furnishes poultry to a grower and the grower agrees to feed and care for the birds and turn them over to the dealer for marketing through a farmer cooperative, both the feed dealer and the grower qualify as producers.[130]

Capital Stock

Strict limitations are imposed on a cooperative organized with capital stock, although the fact that it has capital stock will not disqualify the association for section 521 status.[131] The limitations relate to type of stock that may be issued, the extent to which its ownership may be dispersed, and the rate of dividends that may be paid thereon.

Substantially all the voting stock of an association must be owned by producers who market their products or purchase their supplies through the association. The Internal Revenue Service has said:

> It is impracticable to attempt to define the term "substantially all" as used in the statutes under discussion for the reason that what constitutes substantially all of the capital stock of a cooperative marketing association is a question of fact, which must be decided in the light of the circumstances surrounding each particular case. Any ownership of stock by other than actual producers must be explained by the association. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to actual producers who market their products through the association. However, if by statutory requirement the officers of an

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[129] *Dr. P. Phillips Cooperative,* 17 T.C. 1002 (1951).

[130] Rev. Rul. 58-483, 1958-2 Cum. Bull. 277. From an antitrust standpoint, the Department of Justice has raised the question whether a member who uses "contract growers" is a producer. See Justice Press Release dated November 17, 1971.

[131] Int. Rev. Code of 1954, § 521(b)(2).

association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption; or if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional inhibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. On the other hand, where a substantial part of the stock was voluntarily sold to nonproducers, exemption must, under the statute, be denied as long as such stock is so held.[132]

Where 12 percent of the outstanding common stock of a marketing association was held by nonproducers with over 9 percent of such stock having been voluntarily sold or issued to persons who were neither farmers nor producers, it was held in 1926 that "substantially all" the common stock was not owned by producers and the association was not entitled to exemption.[133] This ruling is cited because it is one of the earliest on the subject of "substantially all." However, although not specifically revoked or superseded, this ruling has been declared obsolete by the Internal Revenue Service along with a number of other rulings that are not considered determinative with respect to future transactions.[134] This action by the Service is part of its program of reviewing rulings published in the Internal Revenue Bulletin prior to 1953.[135]

The Board of Tax Appeals[136] has ruled that "substantially all" of the voting stock of a cooperative was held by producers where

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[132]Mim. 3886, X-2 Cum. Bull. 164 (1931). Of course, patrons of a stock association who do not own at least one share of stock, may not be counted as "shareholders." Their patronage would represent "nonmember" business. *Producers Livestock Marketing Association of Salt Lake City,* 45 B.T.A. 325 (1941). *Cf. In re Temtor Corn & Fruit Products Co.,* 299 F. 326 (E.D. Mo. 1924); *Schlafly* v. *United States,* 4 F. 2d 195 (8th Cir. 1925). The courts in these cases considered statutory language similar, but not identical, to the "substantially all" stock requirement.

[133]G.C.M. 557, V-2 Cum. Bull. 71 (1926).

[134]Rev. Rul. 69-30, 1969-1 Cum. Bull. 306.

[135]Rev. Proc. 67-6, 1967-1 Cum. Bull. 576.

[136]*Farmers Co-operative Creamery,* 21 B.T.A. 265 (1930), *acq.,* 1957-2 Cum. Bull. 4.

194 shares of 213 outstanding shares were owned by "persons who were producing owners either directly or on a crop-share basis." Nineteen shares were owned by persons who were not producers during the year in question, but seven of those 19 individuals "had been producers when the stock was acquired and one was the widow of a former producer." The Board also found that of the 194 shares "167, or 79 percent, were held by operating farmers and 27 by persons who operated their farms by tenant farmers and received a crop share (including dairy products)."

The lack of certainty that has accompanied the Service's interpretation of the quantitative meaning of "substantially all" as used in section 521(b)(2) has now been removed by the publication of Revenue Ruling 73-248. 1973-1 Cum. Bull. 295. This ruling holds that the "substantially all" test is satisfied if at least 85 percent of the total shares of capital stock of a farmers' cooperative (other than nonvoting preferred stock for which the owners' participation in the profits is limited to no more than the fixed dividends) is held by producers.

Two recent court decisions[137] have construed the language of section 521 of the Code providing that 521 status shall not be denied because a cooperative has capital stock " * * * *if substantially all such stock * * * is owned by producers who market their products or purchase their supplies and equipment through the association.*" (Emphasis added.)

In the *Co-operative Grain & Supply Co.* case, it was held that in order for a cooperative to qualify under this language "substantially all of the shareholder-producers are required to market their products and purchase their supplies through the taxpayer on a current basis." The court said flatly: "That is our holding." It then added this highly significant footnote:

> Neither taxpayer nor amicus has discussed the question of the *amount or quantity* of products which currently must be sold or supplies purchased through the cooperative. The Tax Court did not specifically discuss or resolve this issue. As we read the record this matter was not in controversy, at least not directly. The

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[137] *Co-operative Grain & Supply Co.* v. *Commissioner,* 407 F. 2d 1158 (8th Cir. 1969) and *Petaluma Co-operative Creamery* v. *Commissioner,* 52 T.C. 457 (1969). See Guenzel, *So-Called "Exempt" Cooperatives,* American Cooperation—1970, 64 at 67.

> Commissioner in brief, however, assumes that *substantially all* of the shareholders-producers must market *substantially all* of their products and purchase *substantially all* of their supplies through the cooperative. The posture of the record is such that we refrain from deciding this question. We do suggest, however, that imposition of the standard proposed here by the Commissioner could produce impractical and perhaps oppressive results. We believe the Tax Court, on remand, should resolve this question, if it becomes an issue, by application of a reasonable and realistic standard.

This case arose on the cooperative's petition to review the Tax Court's decision where the following statement had been made with respect to the words "substantially all" in section 521 (b) (2):

> Petitioner, however, went no further than to argue that substantially all of its shareholders were producers. It made no attempt to argue that its shareholder-producers were active patrons of the association during the years in issue. Nor did petitioner offer any evidence with the purpose of proving this point. Consequently, although we find that substantially all, if not all, of petitioner's shareholders were producers during the years in issue, we cannot find that substantially all of petitioner's shareholders were active producers, that is—producers who marketed their products or purchased their supplies and equipment through the association.[138]

The cooperative asserted before the Court of Appeals that it was in a position to establish in another hearing that it satisfied the "current patronage" test; that it was not an issue below and was raised for the first time by the Tax Court in its decision. The Court of Appeals concluded "that in the interest of justice, the case should be remanded to the Tax Court to afford the taxpayer a full opportunity to produce additional evidence on the question of current patronage."

In the *Petaluma Co-operative Creamery* case, the Tax Court decided its first case involving the "substantially all" language of

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[138]T.C. Memo. 1967-132.

section 521 (b) (2) following the decision of the Court of Appeals in the *Co-operative Grain & Supply Co.* case.

In *Petaluma,* section 521 status had been denied, in part, because, according to the Commissioner, substantially all of the cooperative's stock was not owned by producers who marketed their products through the cooperative. The Tax Court found that during 1958 only about 45 percent of the shareholders delivered "butterfat" to the cooperative. The shareholders, according to the court, owned approximately 72 percent of the outstanding stock.

During 1959, only about 43 percent of the shareholders delivered "butterfat" to the cooperative. And, again according to the court, these shareholders owned approximately 70 percent of the outstanding stock. The remaining shareholders "either had discontinued dairy production or preferred to sell their butterfat to companies such as Safeway, Borden, and Foremost."

In its decision, the Tax Court considered as shareholder-producers only "those patrons who delivered some butterfat" to the cooperative during 1958 or 1959. The court noted that it did not consider it necessary to go into the question of the "amount or quantity of products which currently must be sold to the cooperative," referring to the footnote quoted above from the *Co-operative Grain & Supply* case.

The Court of Appeals decision is taken by the Tax Court as a statement that it (the Tax Court) "is on sound ground" in concluding that section 521(b)(2) requires "current patronage" by shareholder-producers. "Section 521 does not," concludes the Tax Court, "define the term 'substantially all.' For purposes of the instant case, we do not deem it necessary to decide exactly what percentage will be sufficient for purposes of section 521. In any event, we do not think that 70 or 72 percent is enough under the facts in this case to constitute 'substantially all.' "

There appear to be two earlier cases which have alluded to what is now being labeled a "current patronage" requirement. In the first case,[139] the Board of Tax Appeals said "there is no evidence that all the members of each of such organizations are producers of commodities that are marketed through the petitioner as their agent." In the second case,[140] the Board pointed out that the "evidence fails to show that all of its shareholders purchased their supplies and equipment through petitioner." In both cases, however, qualification clearly failed for other reasons.

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[139] *Co-operative Central Exchange,* 27 B.T.A. 17, at 20 (1932).

[140] *Farmers Union Cooperative Oil Co.,* 38 B.T.A. 64, at 72 (1938).

In none of the cases have the courts defined in precise terms what is meant by "current patronage." The Court of Appeals has called for a "reasonable and realistic" standard in resolving the question of the "amount or quantity of products which currently must be sold or supplies purchased" through a cooperative. The Internal Revenue Service will certainly accept this admonition.

The Internal Revenue Service has ruled[141] that a cooperative must restrict stock ownership to producers of agricultural products as far as possible. A cooperative furnished farm supplies and equipment to its patrons through numerous sales outlets. It issued common stock with a par value of $1 a share. Only common stockholders could vote, and the charter provided that ownership of this class of stock was restricted to producers of agricultural products. Records of business transacted with individual patrons were kept so that patronage refunds might be paid to the patrons on the basis of their purchases from the cooperative. If the patron was a holder of common stock, the refund was issued in nonstock form. If the patron was not a holder of common stock, a share of such stock was mailed to him together with a letter requesting that he return the stock for redemption if he were not actively engaged in farming. The Service concluded that these practices were not adequate.

The regulations[142] under section 521(b)(2) provide that ownership of stock by others than actual producers must be satisfactorily explained in the association's application for exemption, and that the association will be required to show that the ownership of its capital stock has been restricted as far as possible to actual producers. This regulation states that the restriction on the ownership of an association's capital stock to actual producers is a continuing requirement.

Revenue Ruling 67-204 makes it clear that a cooperative that does not determine as far as possible that a prospective stockholder is a producer before issuing stock to him and which takes no other action to assure that the ownership of its stock is in fact restricted as far as possible to actual producers does not comply with the requirements of the statute and regulations. An inference drawn from failure to respond to the request to return the stock if the patron is not a producer does not meet these requirements.

On the other hand, the Service holds that a cooperative will not be denied section 521 status merely because a substantial part

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[141]Rev. Rul. 67-204, 1967-1 Cum. Bull. 149.

[142]Treas. Reg. § 1.521-1(a)(2).

of its voting stock is held by a membership committee as trustee for the members. Stock so held qualifies as stock owned by producers who market their products or purchase their supplies and equipment through the cooperative.[143]

Dividends on Stock

If dividends are payable on capital stock, the rate must be fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued.[144]

Payment of a 10-percent dividend exceeded the statutory limitation (the maximum legal rate in the State being 8 percent) and the cooperative did not qualify.[145] The limitation on dividends is based, not on the par value of the stock, but on the consideration paid for the shares.

Where a cooperative issued additional shares of stock to stockholders as dividends for which the stockholders paid nothing, the Board of Tax Appeals said[146] that this "fact alone bars petitioner from claiming exemption from income tax; for after the declaration of the stock dividends, the stockholders were receiving from 12 to 18 percent per annum on the amounts invested by them."

The issuance by a cooperative of a nontaxable stock dividend to its shareholders did not increase the "value of the consideration

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[143]Rev. Rul. 56-21, 1956-1 Cum. Bull. 208.

[144]Int. Rev. Code of 1954, § 521(b)(2).

[145]*South Carolina Produce Association* v. *Commissioner,* 50 F. 2d 742 (4th Cir. 1931).

[146]*Farmers Mutual Cooperative Creamery,* 33 B.T.A. 117, 125 (1935). See also *Laura Farmers Cooperative Elevator Co.* v. *United States,* 273 F. Supp. 1019 (S.D. Ill. 1967), where the court concluded that no consideration was received by the cooperative (transfer of part of earned surplus to capital) for which certain preferred shares were issued, beyond the amount of the shareholders' original investment, and, therefore, dividends paid on such shares admittedly exceeded the allowable limit of 8 percent of the value of that consideration. In *Etter Grain Company* v. *United States,* 331 F. Supp. 283, 286 (N.D. Tex. 1971), *affirmed,* 462 F. 2d 259 (5th Cir. 1972), the court said the "question of valuation would not be presented if, as an example, a new cooperative corporation was formed and each stockholder invested cash for his preferred shares. But here, where stock is exchanged, the value to be used for Sec. 521 purposes is the investment value of each stockholder in the old corporation, not its re-evaluation as was used by Plaintiff in this case. * * * To hold otherwise, would only open another door or afford another device and method for operating a co-op for the advantage of the stockholders rather than the member-producers."

for which the stock was issued" for the purpose of the dividend limitation provided by section 521(b)(2).[147]

Revenue Ruling 69-431[148] holds that a farmer cooperative does not qualify under section 521 if its stockholders (common or preferred) are permitted to participate as stockholders in the "profits" of the cooperative beyond the amount of dividends payable on their stock in case of dissolution or upon redemption of the stock. The Code does not specifically cover the participation rights of stockholders in event of dissolution or stock redemption (other than nonvoting preferred stock). The ruling states:

> While the Code does not specifically cover the participation rights of stockholders in the profits of an exempt cooperative in the event of dissolution or stock redemption (other than the holders of nonvoting preferred stock), section 521(b)(1) of the Code does require operation at cost in that all net earnings from marketing and purchasing must be returned to patrons on the basis of their patronage. This includes any earnings set aside for surplus or reserves. *Fertile Cooperative Dairy Association* v. *Huston,* * * *. Moreover, since an exempt farmers' cooperative is required to operate for the benefit of its patrons, earnings from nonpatronage sources (such as that derived from investments, the sale of assets, and business done with or for the United States) must also be distributed to the patrons on a patronage basis.
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> Therefore, although stockholders may share in the profits of an exempt farmers' cooperative, they may do so only on the basis of their patronage rather than on the basis of shares of stock that they may own. Neither common nor preferred stockholders may participate in the profits of an exempt farmers' cooperative, upon dissolution or otherwise, beyond the fixed dividends.

Reserves

Qualification under section 521 is not denied a cooperative because it accumulates and maintains "a reserve required by State

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[147]Rev. Rul. 68-169, 1968-1 Cum. Bull. 286.
[148]1969-2 Cum. Bull. 133.

law or a reasonable reserve for any necessary purpose."[149] The regulations mention as examples of permissible reserves those "to provide for the erection of buildings and facilities required in business or for the purchase and installation of machinery and equipment or to retire indebtedness incurred for such purposes."[150] The regulations also state that a cooperative must establish that "it has no taxable income for its own account" other than that reflected in the above authorized reserves or surplus.[151] But no "unallocated" reserves are permissible.

It is clear that reserves may be accumulated for what are essentially capital purposes. An association may set aside reserves for any necessary purpose, provided they are reasonable in amount; and, of course, there is no question but that an association may accumulate reserves which are required by State law. If reserves, other than those required by State statute, are regarded as excessive, section 521 status could be lost.

On the other hand, valuation or expense reserves such as those for depreciation and bad debts are permitted as a part of operating costs and are not a segregation of surplus. Depreciation may be deducted from gross income by any corporation, including a cooperative, as a business expense because it represents one of the costs of doing business. Depreciation expense should be reasonable and related to the useful life of the depreciable property; otherwise, it will be unfair to the members who patronize the association in a particular year. Moreover, any amount representing excessive depreciation is subject to disallowance for income tax purposes, and, if disallowed, it has been considered taxable income.[152]

It appears to be recognized that an association may accumulate reserves for carrying it over poor years.[153]

An association may invest funds from reserves in a building to furnish a permanent home for the organization, and the fact that

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[149]Int. Rev. Code of 1954, § 521 (b)(3).

[150]Treas. Reg. § 1.521-1(a)(3).

[151]Treas. Reg. § 1.521-1(c). See also *Fertile Cooperative Dairy Association* v. *Huston,* 119 F. 2d 274 (8th Cir. 1941).

[152]*Railway Express Agency, Inc.* v. *Commissioner,* 169 F. 2d 193 (2d Cir. 1948), *affirming* 8 T.C. 991 (1947), holding that this cooperative composed of various railroad companies and organized on a basis which required it to pay to them all receipts over operating costs and expenses, was liable for income taxes on amounts representing excessive depreciation which it had taken on its property.

[153]S.M. 2286, III-2 Cum. Bull. 236 (1924), declared obsolete but not revoked or superseded by Rev. Rul. 70-319, 1970-1 Cum. Bull. 284. See discussion at footnotes 134 and 135, in this section.

this is done through the medium of another corporation will not operate to deprive the association of its exemption.[154]

If the reserves of an association are reasonable in amount and for a necessary purpose, the fact that reserve funds may be invested in Government bonds or other securities which yield a return to the association should not adversely affect qualification.[155]

The accumulation and maintenance of reserves by cooperatives is sometimes criticized—the charge being that they thereby gain a tax-free method of capitalization. This is unwarranted, however, since section 521 confers no tax exemption. Any reserves accumulated must be reasonable in amount and for necessary purposes. Moreover, all patrons, including nonmembers, who through their patronage contribute to such reserves should have allocated or apportioned to them their contributions to such reserves or, at least, the cooperative should maintain such permanent records of the patronage and equity interests of all members and nonmembers that such apportionment can be made.

As explained, these reserves must be "allocated" if they are to be claimed as a current exclusion or a later deduction from income for tax purposes. The allocation may be in the form of "qualified" or "nonqualified" written notices of allocation as these terms are described in section 1382 (b) of the Code. In connection with this subject, the revolving-fund plan of financing[156] is well adapted to the plan of capitalizing an association through properly apportioning or allocating to the patrons the amounts in excess of expenses.

In a case in which the court held that an association was not exempt from the payment of Federal income taxes, it was said:

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[154]See footnote 153 in this section. See also *Koon Kreek Klub* v. *Thomas,* 108 F. 2d 616 (5th Cir. 1939). But see *West Side Tennis Club* v. *Commissioner,* 111 F. 2d 6 (2d Cir. 1940).

[155]See *Niles* v. *Central Manufacturers' Mutual Insurance Co.,* 252 F. 564 (6th Cir. 1918).

[156]See "Obligation to Finance," p. 357, "Capital Retains," p. 443, and "Revolving-Fund Plan of Financing," p. 480. For a bylaw provision, see "Sample Legal Documents," p. 578. See also Griffin and Wissman, *Financial Structure of Farmer Cooperatives,* FCS Res. Rpt. 10, Farmer Cooperative Service, U. S. Dept. Agr. (1970); Davidson, *How Farm Marketing Cooperatives Return Savings to Patrons,* FCS Res. Rpt. 7, Farmer Cooperative Service, U. S. Dept. Agr. (1970); Griffin, *A Financial Profile of Farmer Cooperatives in the United States,* FCS Res. Rpt. 23, Farmer Cooperative Service, U. S. Dept. Agr. (1972).

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> In fact, under the bylaws which were in force at this time, there was no way in which nonmembers could acquire an interest in the surplus and reserve which had been created. Besides this, it appears that no account or credit was ever set up on the books with reference to patronage dividends attributable to the business done with nonmembers, and there was no basis upon which they could make a legal claim to share in the profits of the business which had been done with them. It is clear, therefore, that plaintiff did not comply with the condition of tax exemption, namely, that the association shall be organized and operated for the purpose of turning back to the "members or other producers" the profits or savings on the basis of the quantity or value of the business done with each of such persons.[157]

Nonmember-Nonproducer Business

Section 521 imposes limitations on the extent to which a qualifying cooperative may do business with nonmembers and nonproducers. A marketing cooperative may, of course, sell the products of its patrons to anyone without regard to whether the purchasers of such products are producers or members of the cooperative. By the same token, a supply cooperative may purchase items from suppliers or anyone else without regard to the producer or membership status of the seller.

The statute expresses the limitation on business with nonmembers by affirmatively stating that 521 status "shall not be denied any such association which markets * * * or which purchases * * * for nonmembers in an amount the value of which does not exceed the value * * * for members."[158] This has been construed to mean that a marketing cooperative may not market more products (based on dollar rather than unit volume) for nonmembers than it does for members.[159] The statute then adds a proviso with respect to purchasing activities of a cooperative in these words "provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases."[160]

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[157] *Farmers Cooperative Co.* v. *United States,* 23 F. Supp. 123 (Ct. Cl. 1938).

[158] Int. Rev. Code of 1954, § 521(b)(4).

[159] *Producers Livestock Marketing Association of Salt Lake City,* 45 B.T.A. 325 (1941); *Farmers Union Cooperative Association,* 44 B.T.A. 34 (1941).

[160] Int. Rev. Code of 1954, § 521(b)(4).

Exceptions have been made to a strict construction of these limitations. While a marketing cooperative generally will not qualify if it markets products of nonproducers, certain "emergency" and "ingredient" purchases and "sideline sales" are permitted.

A 1969 ruling[161] recognizes that the section 521 status of a farmer cooperative will not be adversely affected by emergency purchases from nonproducers to fulfill outstanding orders based on normal crop expectations. The ruling relates a factual situation where a fruit marketing association was unable to meet its contract commitments because many producers in the cooperative's growing area lost their crops in an unexpected freeze. The ruling cautions that the emergency purchases "must be made for the sole purpose of meeting pre-existing contractual commitments to facilitate dealings with member patrons and not for the purpose of investment or profit."

The Service has long recognized the right of a section 521 cooperative to purchase items commercially from nonproducers to put farm products in a marketable condition. Such purchases are called "ingredient" purchases. Marketing has been construed to include manufacturing, and changing the form of raw materials, when necessary, in marketing agricultural products. For this purpose, it often happens that a cooperative must get products its own producer patrons do not grow. Ice cream, for example, made from the milk products of the member-patrons, would necessitate the purchase of sugar and other ingredients. Other examples are readily apparent. Such "ingredient" purchases are permissible so long as they are necessary in putting the agricultural product in a marketable condition.

Revenue Procedure 67-3, 1967-2 Cum. Bull. 668, sets up guidelines for determining permissible "sideline sales" by a section 521 cooperative. Used as an example is a dairy marketing cooperative selling, as a sideline, fruit juices and eggs not produced by member-patrons. The guidelines provide that nonproducer items must be necessary to the effective marketing of the items which the cooperative's members produce. Where that condition is met, the sideline sales are considered as incidental to the cooperative's marketing of products for producer members if the dollar volume

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[161]Rev. Rul. 69-222, 1969-1 Cum. Bull. 161.

of the incidental sales does not exceed 5 percent of the total retail sales of the marketing function. If the sideline sales exceed 5 percent, a determination as to whether these sales are a necessary supplement to the efficient marketing of the producer items will be made on the basis of all the facts and circumstances in the particular case.[162]

The Internal Revenue Service has reversed (with prospective effect from August 4, 1969) a portion of a 1954 ruling[163] that allowed sales of byproducts not usable by the members of a supply cooperative to be disregarded in computing the 15 percent nonmember-nonproducer business limitation of section 521(b)(4) of the Code. The new ruling [164] holds that *sales* (as distinguished from exchanges) of byproducts such as heavy fuel oils and distillates may not be disregarded in computing the 15-percent limitation. The ruling also stresses the requirement of the Code that supplies and equipment be turned over to members or other persons at actual cost, plus necessary expenses, and that therefore the cooperative must show that the purchasers of such byproducts are entitled to share in patronage refunds on the same basis as all other patrons of the cooperative.

Remaining in effect, however, is the holding in Revenue Ruling 54-12 that the value of petroleum products *exchanged* with other refineries to effect a saving in transportation costs shall, for purposes of the 15-percent test, be disregarded.

These rulings relating to product exchanges should be compared with Revenue Ruling 67-346[165] dealing with an exchange of *unlike* products, whereas *like* products were involved in Revenue Rulings 54-12 and 69-417.

Revenue Ruling 67-346 holds that an exchange of the cooperative's surplus products for *unlike* products processed by a nonmember-nonproducer which were later sold to the cooperative's patrons, may not be disregarded in determining

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[162]See *Land O'Lakes, Inc.* v. *United States,* 362 F. Supp. 1253 (D. Minn. 1973), where retail sales of nonproducer goods were 17 percent of total retail sales of the marketing activity. The court found that this was incidental to the effective marketing of producer goods and did not violate sec. 521. The Government has appealed.

[163]Rev. Rul. 54-12, 1954-1 Cum. Bull. 93. See also text at footnote 119, in this section.

[164]Rev. Rul. 69-417, 1969-2 Cum. Bull. 132.

[165]1967-2 Cum. Bull. 216.

the 15-percent nonmember-nonproducer limitation of section 521(b)(4). Moreover, the ruling concludes that since the exchanges are considered the same as sales to nonmember-nonproducers, such persons are entitled to patronage refunds on the same basis as other patrons of the cooperative.

Where a marketing cooperative marketed products *purchased* by members which exceeded the value of the products *grown or otherwise produced* by members for whose accounts such products were marketed, the cooperative violated the limitation placed on business done with "nonmembers" under section 521 of the Code. Furthermore, by marketing products of nonmembers as those of its members, the cooperative did not meet the statutory requirement that proceeds of the sale of products, less necessary operating expenses, be returned to producers on the basis of the quantity or value of products furnished by them.[166]

The cooperative involved in this ruling packed, shipped, and marketed fruit supplied by members, a substantial amount of which was not produced by them, but was *purchased* on the open market. During each of the years in question the value of the fruit purchased by members and marketed by the cooperative exceeded the value of fruit marketed by the cooperative which was grown or otherwise produced by the members. Net margins from operations were allocated to members on the basis of the value of the products furnished by them.

The term "products" as used in the Code, according to this ruling, refers to *products grown or otherwise produced by the patron for whose account such products are marketed.* Products grown by one who is not a member of the marketing cooperative must be treated as "products of nonmembers," notwithstanding such products are marketed by the cooperative in the name of, or for the account of, a member.

The ruling cites *Dr. P. Phillips Cooperative.*[167] In that case the Tax Court construed section 101(12) of the Internal Revenue Code of 1939—the section corresponding to section 521 of the 1954 Code. The question at issue concerned the

[166]Rev. Rul. 67-152, 1967-1 Cum. Bull. 147.
[167]17 T.C. 1002 (1951).

marketing of products *purchased* by members, as distinguished from products *produced* by them. The court held that one who merely purchases a ripe crop at harvest and markets it through a cooperative would not be a farmer, a fruitgrower, or producer within the meaning of that section of the Code.

Under some special conditions, it appears from early rulings that an association may purchase agricultural commodities of the type which it is engaged in handling from others engaged in the same line of business without having this operate to deprive the association of its 521 status.[168]

In an early court case in which it appeared that the cooperative had purchased "small quantities of poultry and eggs from dealers" as well as from producers to facilitate the marketing of the balance of the products which it handled in meeting contractual commitments, and the products which were so purchased were not handled at a profit, it was held that this did not operate to deprive the association of its exemption.[169]

One way of avoiding the effect of the restriction under discussion is to make all purchases other than from members or nonmember producers only from other section 521 farmer cooperatives, if this is feasible. Purchases from other cooperatives have been considered in the category of purchases from "producers."

If an association buys commodities under special circumstances from nonmembers who are dealers, the question arises as to whether it must pay patronage refunds to such dealers on the same basis as it pays such refunds to patrons generally. The answer is, "No." Since a marketing cooperative should not ordinarily be making such purchases, they are not regarded as part of the cooperative's normal marketing operations.

A more difficult question, however, is what to do about the association's net margins, if any, on such transactions. If the

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[168] I.T. 1598, II-1 Cum. Bull. 159 (1923), declared obsolete but not revoked or superseded by Rev. Rul. 70-319, 1970-1 Cum. Bull. 284. See discussion at footnotes 134 and 135, in this section.

[169] *Producers' Produce Company* v. *Crooks*, 2 F. Supp. 969 (W.D. Mo. 1932). See also *Land O'Lakes, Inc.* v. *United States*, 362 F. Supp. 1253 (D. Minn. 1973), discussed at footnote 162 in this section.

association is able to establish that these transactions were handled at a loss or on a break-even basis, this would seem to furnish a clear justification for not paying a patronage refund to the dealer, and there is no problem as to the disposition of margins.[170]

In several unpublished rulings made prior to the 1951 amendment, the Internal Revenue Service allowed an "exempt" cooperative to distribute savings on these dealer transactions among other patrons in proportion to their patronage. They were in effect treated as "income not derived from patronage." Perhaps a good case could be made for concluding that they may still be handled in this way. However, there is an alternate method of handling which would seem less likely to be questioned by the Internal Revenue Service. This method is to exclude the amount of the savings on the transactions with dealers from funds allocated on a patronage basis, and, if necessary because sufficient offsets are not available, pay a tax on them.

The term "supplies and equipment" in section 521 has been construed to include "groceries and all other goods and merchandise used by a farmer in the operation and maintenance of a farm or farmer's household."[171]

In interpreting the 15-percent rule under section 531(b)(4) of the Code, a 1967 ruling[172] holds that purchases by a farmer for use in a nonfarming business must be treated as purchases made for persons who are neither members nor producers. The cooperative involved handled, in addition to other farm supplies, gasoline which it sold to members and nonmembers. One member operated a trucking business as well as a farm. His gasoline purchases for the trucking business were considered nonmember-nonproducer business.

Equality of Treatment Between Members and Nonmembers

To qualify under section 521, a cooperative must afford

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[170]See *Fertile Cooperative Dairy Association* v. *Huston,* 119 F. 2d 274, 277 (8th Cir. 1941), *aff'g* 33 F. Supp. 712 (N.D. Iowa, 1940).

[171]Treas. Reg. § 1.521-1(b). See also *Farmers Union Cooperative Association,* 44 B.T.A. 34 (1941).

[172]Rev. Rul. 67-223, 1967-2 Cum. Bull. 214.

all patrons, members and nonmembers alike, equality of treatment. The regulations[173] use the words "nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned." The equality of treatment requirement, however, has not been confined to patronage allocations but has been extended by cases and rulings to other activities.

For example, in *Fertile Cooperative Dairy Association* v. *Huston*,[174] the court said that "if part of the proceeds of nonmembers' products is to be used to create or maintain a surplus and to make additions to the capital assets of the association, without allowing them a proportionate distributive interest in the permanent value contributed by such surplus accumulations or capital assets additions, it must be held that the association to that extent is being operated for profit to members, as against nonmember patrons, and that it is not exempt from taxation."

Another cooperative did not qualify[175] because certain members and nonmembers received supplies at cost plus expenses, but other members and nonmembers were charged retail prices.

It has long been the practice of the Internal Revenue Service to permit cooperatives to apply toward the purchase of a

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[173]Treas. Reg. §1.521-1(a)(1). Qualification was denied where patronage refunds were made to members only. *Farmers Union Cooperative Co.* v. *Commissioner,* 90 F. 2d 488 (8th Cir. 1937), *affirming* 33 B.T.A. 225 (1935); *Farmers Mutual Cooperative Creamery*, 33 B.T.A. 117 (1935); *Farmers Cooperative Co., Wahoo, Nebr.*, ¶35,363 P-H Memo B.T.A. (1935). Qualification denied where nonmember patrons were not entitled to share in "profits." *Farmers Union Cooperative Supply Company of Stanton, Neb.* v. *United States*, 25 F. Supp. 93 (Ct. Cl. 1938); *Council Bluffs Grape Growers Association*, 44 B.T.A. 152 (1941); *Farmers Cooperative Company of Wahoo, Neb.* v. *United States*, 23 F. Supp. 123 (Ct. Cl. 1938). Rev. Rul. 73-59, 1973-1 Cum. Bull. 292, holds that a livestock marketing cooperative, prohibited under the Packers and Stockyards Act of 1921 from distributing patronage refunds to nonmembers, does not qualify for section 521 status even though the cooperative credited to a patronage refund "suspense" reserve, amounts equal to the patronage refunds the nonmembers would have received had they been members.

[174]119 F. 2d 274 (8th Cir. 1941).

[175]*Farmers Union Cooperative Oil Co.,* 38 B.T.A. 64 (1938). See also *Fruit Growers' Supply Co.* v. *Commissioner,* 56 F. 2d 90 (9th Cir. 1932); S.M. 2595, III-2 Cum Bull. 238 (1924), declared obsolete but not revoked or superseded by Rev. Rul. 70-319, 1970-1 Cum. Bull. 284. See discussion at footnotes 134 and 135, in this section.

share of stock or membership in a cooperative the margins that accrue on nonmember business.[176] Of course, such nonmembers should be producers so that the cooperative would not lose its 521 qualification by reason of admitting nonproducers to membership.

Sometimes a cooperative's bylaws provide that if the savings on the business of a nonmember do not, within a stated period of time, say 1 year, amount to the sum required for paying for a share of stock or for membership, the credit in favor of such nonmember shall be canceled and the amount in question carried to the general reserves of the association. Depending upon the par value assigned to the stock, such action might cost an association its 521 status, because if more than nominal amounts are involved, nonmembers would not be dealt with by the association on the same basis as members.

The Internal Revenue Service has ruled, however, that small patronage refunds of less than $1 or the cents payable in excess of whole dollar amounts may be retained by a section 521 cooperative without affecting its qualification.[177] This same ruling also holds that:

> Where a farmers' marketing and/or purchasing association issues either a certificate of stock representing a patronage dividend or a check representing a dividend payable on its stock, the mailing of either of such instruments to the patron would constitute payment for Federal income tax purposes in the year of issue, and such refunds will be allowed as deductions from gross income where, in the ordinary handling of the mail, delivery cannot be made and the association holds the instrument subject to the claim of the rightful owner.

Not only may an association be denied 521 status because it does not deal with members and nonmembers on the same basis, but an association may be denied such status because it does not maintain substantial equality among its members.[178]

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[176]Rev. Rul. 69-52, 1969-1 Cum. Bull. 161. See footnote 173 in this section.

[177]Rev. Rul. 55-141, 1955-1 Cum. Bull. 337. These amounts, unless allocated to patrons on the basis of patronage, would be taxable to the cooperative.

[178]*Farmers Union Cooperative Oil Company,* 38 B.T.A. 64 (1938).

If an association is handling a number of different commodities, with net margins on all of them, and it elects to pay a patronage refund to the producers of only one commodity, this could deprive an association of its 521 status because of the inequality of treatment accorded to patrons.

As indicated, an association "may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members." However, inasmuch as the statute requires that an association must be organized for the "purpose of marketing the products of members or *other producers,*" it would seem that an association would not qualify under section 521 if it regularly purchases from dealers or on commodity exchanges any substantial quantity of the commodities which it is engaged in handling.

To reduce the recordkeeping involved in making the 20-percent cash payment under section 1388(c) of the Code tc qualify patronage allocations, a cooperative has been allowed to make full payment in money or qualified check to patrons entitled to refunds of less than $10. Patrons entitled to more than $10, receive $10 or 20 percent of the refund, whichever is greater.[179]

The regulations[180] state that a cooperative will not be denied section 521 status merely because it makes payments solely in nonqualified written notices of allocation to patrons who do not consent as provided in section 1388 of the Code, but makes payments of 20 percent in cash and the remainder in qualified notices to those patrons who do so consent. It is also permissible to make payments of less than $5 to consenting patrons solely in nonqualified form, while payments of $5 or more are made—20 percent in cash and the remainder in qualified form.

Under this same regulation, a cooperative may pay a smaller amount of interest or dividends on nonqualified allocations held by nonconsenting patrons than it pays on qualified allocations held by consenting patrons. The same rule applies to per-unit retain certificates. There is this proviso, however: The amount of interest or dividend reduction must be reasonable in relation to the fact that the cooperative receives no tax benefit

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[179]Rev. Rul. 66-152, 1966-1 Cum. Bull. 155.

[180]Treas. Reg. §1.521-1(f).

with respect to nonqualified allocations (including nonqualified per-unit retain certificates) until redeemed.

A cooperative will lose its 521 status, however, if, in any other respect, it treats nonconsenting patrons differently from consenting patrons with respect to the payment of patronage refunds or allocations, or with regard to the redemption of allocations or per-unit retain certificates.

A question involving the allocation of nonpatronage income by a section 521 cooperative was before the Tax Court in *Juniata Farmers Cooperative Association.*[181] The cooperative's method of allocation for the years 1958 and 1959 was upheld as one acceptable within the meaning of section 522(b)(1)(B) of the Code and the regulations.

The cooperative operated a grain department and feed and fertilizer departments. The grain department stored and sold grain while the other two departments performed purchasing functions. For the years in question, the cooperative received "nonpatronage income" from the Commodity Credit Corporation which it allocated to the patrons of its grain department only. Substantially all grain department patrons, however, were also patrons of the other two departments.

Section 522 (b) (1) (B) of the Code provided that a cooperative may deduct from its gross income "amounts allocated during the taxable year to patrons with respect to its income not derived from patronage." The regulations under this section contain the following:

> As used in this paragraph, the term "income not derived from patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. *** Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable, it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable.[182]

[181]43 T.C. 836 (1965), *acq.*, 1966-2 Cum. Bull. 5.

[182]Treas. Reg. §1.522-2(d). Handling and storage charges paid to a farmer cooperative under the "reseal" program by the Commodity

The nonpatronage income allocated to patrons of the grain department had been on the basis of the bushels of grain they delivered to the grain elevator. The Commissioner contended that this did not meet the requirements of the statute, insisting that the allocation should also have been to the patrons of the two purchasing departments. The court did not agree. The method of allocation was, the court concluded, a fair and equitable result for the patrons who were fully cognizant of the method used and (it was stipulated) deemed it acceptable. Having reached this conclusion, the court rejected the Commissioner's alternative argument that failure to allocate nonpatronage income to all patrons caused the cooperative to lose its section 521 status.

The factual situation in this case may explain, in part, the relative ease with which the court found for the cooperative. The court, however, quoted with approval the observation of the Eighth Circuit Court of Appeals in *Pomeroy Cooperative Grain Co.* v *Commissioner*.[183] In *Pomeroy*, the Court of Appeals questioned the standing of the Commissioner to object to a method of allocation which apparently was acceptable to the member-patrons as an equitable distribution.

The court in *Pomeroy* also stated that, from a revenue standpoint, "the Commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members."

The *Juniata* decision would seem to restrict the Commissioner in prescribing a particular method of allocation under the "equitable treatment rule." The value of the case, however, may be limited to situations involving departmental activities where "substantially all of the patrons" of one department are also patrons of other departments. A showing that the method of allocation used was "fully acceptable" to the patrons concerned may also be essential.

In Revenue Ruling 67-128,[184] citing the *Juniata* decision,

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Credit Corporation is income of the cooperative derived from business done with or for the United States and is not income from patronage sources. Rev. Rul. 70-25, 1970-1 Cum. Bull. 17. See also Rev. Rul. 59-107, 1959-1 Cum. Bull. 20, holding that charges paid by CCC following default constitutes income not derived from patronage.

[183]288 F. 2d 326 (8th Cir. 1961).

[184]1967-1 Cum. Bull. 147. In Rev. Rul. 70-420, 1970-2 Cum. Bull. 64, a "nonexempt" cooperative was not allowed to claim a deduction for

a section 521 cooperative is permitted to allocate nonpatronage income and nonpatronage losses to the departments to which such income and losses relate rather than to all of the cooperative's patrons, provided the allocation is not discriminatory among patrons similarly situated.

The cooperative, in operating its several departments, had followed the practice of accounting for the margins and expenses of each department separately. It had consistently allocated the "net earnings" of each department to the patrons of that department. Nonpatronage gains and losses were handled similarly—the cooperative being able to show that the particular nonpatronage income or loss related to the department to which allocated.

Records

To show its qualification for section 521 status, a cooperative must keep permanent business records, reflecting its business transactions with members and nonmembers including distributions to them.[185]

Organization and Operation

Section 521(b) requires a farmer cooperative to be "organized and operated on a cooperative basis." In general, a cooperative is considered to be operated on a "cooperative basis" within the meaning of section 521 if it allocates net margins to patrons on the basis of the business done with or for such patrons. The regulations treat the matter in these words:

> ***In order to show its cooperative nature and to establish compliance with the requirement of the Code that

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patronage refunds representing solely its net margins from member business undiminished by the net loss sustained from transactions with a foreign government, and thereby, according to the ruling, generate a net operating loss. See also Rev. Rul. 70-328, 1970-1 Cum. Bull. 5, where a subchapter T cooperative was held to have no unused investment credit for carryback and carryover purposes in a year during which it has a net operating loss even though it acquired and placed in service 1954 Code section 38 property during the year. *Helena Cotton Oil Co., Inc.*, 60 T.C. 125 (1973), holds to the same effect.

[185]Treas. Reg. §1.521-1(a)(1).

the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of either the quantity or the value of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. ***[186]

Federated Cooperatives

Section 521 contains no specific reference to federated cooperatives. Through longstanding administrative practice and many rulings, however, federated cooperatives have been considered eligible for 521 status.[187]

Revenue Ruling 69-651, published December 29, 1969,[188] prescribes new rules for the qualification of federated cooperatives. It applies what the Service calls the principle of "looking through" to ultimate patrons of member associations in determining eligibility. Four examples or situations illustrate application of the "look through" principle. They involve only purchasing cooperatives, but the ruling adds that "the conclusions are equally applicable to marketing cooperatives." The ruling states:

Farmers' cooperatives may join together to form a federated cooperative to perform more efficient marketing

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[186]Treas. Reg. §1.521-1(a)(1). See Magnuson, *All Farmer Cooperatives And Other Corporations Operating On A Cooperative Basis,* American Cooperation—1970, 69.

[187]S.M. 2288, III-2 Cum. Bull. 233 at p. 235 (1924). This ruling observed: "The principal members of the company are the local citrus growers' associations, which are cooperative, nonprofit corporations, without capital stock, whose members are the local fruit growers. Such a company is entitled to the same status as a company whose members are the farmers or the fruit growers themselves." See also I.T. 2000, III-1 Cum. Bull. 290 (1924). Both of these rulings were declared obsolete but not revoked or superseded by Rev. Rul. 70-319, 1970-1 Cum. Bull. 284. See discussion at footnotes 134 and135, in this section.

[188]1969-2 Cum. Bull. 135. This ruling was first modified by Rev. Rul. 71-

or purchasing functions on behalf of the patrons of the member cooperatives. Since a federated serves the interests of the patrons of its member cooperatives, it is held that it is necessary to look to the patrons of the member cooperatives to determine whether the federated meets the requirements of section 521(b) of the Code. In making that determination, the federated is considered to be dealing directly with the patrons of its member cooperatives. Likewise, in determining control of the federated, it is held that it is necessary to consider the composition of membership of the member cooperatives.

The quoted language introduces problems of eligibility for federations having member cooperatives that do not comply with section 521. There are questions as to how and by what standard determinations will be made as to the member or producer status of business done with and for patrons of such nonqualifying member cooperatives. Three supplemental Revenue Rulings[189] were issued to provide additional guidelines. They discuss three situations to further illustrate the application of the "look through" principle. In addition, Revenue Procedure 72-16[190] sets forth the information from member cooperatives upon which a federated cooperative may rely in establishing and maintaining its qualification under section 521 and the information that it should

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493, 1971-2 Cum. Bull. 240, to postpone the effective date until taxable years beginning on or after July 1, 1971, as to *Situations* 2 through 4 discussed in Rev. Rul. 69-651, wherein a federated cooperative is engaged in transactions with cooperatives some of which do not qualify under sec. 521. Then News Release IR-1294, Feb. 16, 1973, announced suspension of the 1969 "look through" ruling as applied to *Situations* 2 through 4 and included the text of Rev. Rul. 73-138, 1973-1 Cum. Bull. 293—later revoked by Rev. Rul. 73-568, 1973-2 Cum. Bull. 194. The News Release and Rev. Rul. 73-138 point out that this suspension was necessary pending completion by the Service of reconsideration of Rev. Proc. 72-17 (see text at footnote 191 in this section) involving situations where taxable years of a federated and its members are different. Rev. Rul. 73-138 also emphasized that *Situation* 1 of Rev. Rul. 69-651, for which the original effective date of July 1, 1970 still applies, illustrates a clear example of the "look through" principle. The example is one where all the member cooperatives of a federated cooperative qualify under sec. 521 and since the federated deals with them exclusively at cost plus necessary expenses, the federated qualifies under sec. 521.

[189]Rev. Rul. 72-50, 1972-1 Cum. Bull. 163; Rev. Rul. 72-51, 1972-1 Cum Bull. 164. Rev. Rul. 72-52, 1972-1 Cum. Bull. 165.

[190]1972-1 Cum. Bull. 738.

submit with its application and annual return to the Internal Revenue Service. Revenue Procedure 72-17[191] outlines the methods available to a federated cooperative in establishing and maintaining its qualification under section 521 when its taxable year differs from the taxable years of some of its member cooperatives.

Revenue Ruling 69-651 prescribed initially that the effective date for the application of the new principle would be fiscal years of federated cooperatives beginning on and after July 1, 1970. Additional time was needed by the Service to develop supplemental guidelines so that cooperatives could comply. The effective date was therefore postponed to July 1, 1971, as to *Situations* 2 through 4, by Revenue Ruling 71-493, published November 8, 1971, to confirm a News Release, IR-1169, dated October 20, 1971, announcing the postponement. Then, Revenue Ruling 73-138, announced in News Release IR-1294 dated February 16, 1973, suspended application of the "look through" principle to *Situations* 2 through 4 pending completion of the Service study of Revenue Procedure 72-17.

The Internal Revenue Service announced on November 19, 1973 (TIR-1263), that it had completed its study of Revenue Procedure 72-17 and was supplementing it by providing in Revenue Procedure 73-38, 1973-2 Cum. Bull. 501, for an additional method for a federated cooperative and its members to gather information to establish that their operations satisfy the "look through" principle where there are different taxable years. Under Revenue Procedure 73-38 a federated cooperative may take the taxable year of a member that ends within that of the federated and consider it to be the same as the federated cooperative. Although not matching exactly the operations of the federated with that of its members, this method is recognized as one that should produce a result that is acceptable for purpose of the "look through" principle "because the applicable factors do not tend to fluctuate significantly within a short period of time." Revenue Ruling 73-568, also announced on November 19, 1973, revokes Revenue Ruling 73-138 which had suspended Revenue Ruling 69-651, as to *Situations* 2 through 4. It also privides that under "authority provided by section 7805(b) of the Code, the provisions of Revenue Ruling 69-651, as set forth in situations 2 through 4 therein, will not be applied to taxable years beginning before December 17, 1973, the date that this Revenue Ruling" and

[191] 1972-1 Cum. Bull. 739.

Revenue Procedure 73-38 appeared in the Internal Revenue Bulletin.

It is apparent that practical difficulties and excessive costs in the paperwork incident to establishing and retaining evidence of eligibility through application of the new principle will result in many federated cooperatives giving up their qualification under section 521.

Business for the United States

Section 521(b)(5) provides that "Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption * * *." In view of this provision, in any instance in which it has application, the business done by an association for the United States or any of its agencies will not adversely affect the right of the association to qualify. For the provision to have application, however, the association must actually be doing business for the United States or one of its agencies. If an association is merely selling commodities to the United States or one of its agencies, this would not appear to be sufficient.

On the other hand, the language would include an association acquiring or selling commodities for the United States or one of its agencies, in accordance with a contract authorizing the association to do so. Likewise, the storage of commodities by an association for the United States or one of its agencies would also appear to come clearly within the terms of the language. The provision has no application to a State or any subdivision thereof.

It has been held that the language of section 521(b)(5) clearly means that, at least in determining the percentage limitations of the statute relating to nonmember-nonproducer business, the amount of Government business shall be disregarded.

Revenue Ruling 65-5[192] states that a section 521 cooperative will not jeopardize its status if it does business of a marketing or purchasing nature for or with the United States or any of its agencies so long as it otherwise continues to engage in marketing or purchasing activities for its patrons.

The ruling emphasizes that, aside from the Government

[192] 1965-1 Cum. Bull. 244.

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business, the cooperative's activities for its patrons must be such that it may "properly be characterized as a farmers' cooperative" within the meaning of that term as defined in section 521 of the Code.

Taxation of Cooperatives and Patrons Under Subchapter T

The purpose of subchapter T is to assure that amounts received by cooperatives in the course of their business activities with their patrons are included in computing the taxable income of either the cooperative or the patron, thus subjecting these amounts to a single current tax. The choice as to who pays the tax and when it is paid is a choice the law allows the patron to make. Subchapter T and the regulations spell out in great detail just how a patron makes the choice and how both the cooperative[193] and the patron[194] will be taxed.

Distributions of margins by a cooperative to its patrons, including dividends on stock, are not deductible, and do not otherwise reduce a cooperative's gross income for income tax purposes, unless the distributions qualify for deduction under the law.[195] Their qualification depends, for the most part, on whether the patrons are willing to include the amounts distributed as a part of their income. This willingness has to be expressed in one of several forms of consent authorized by the statute.[196] Other requirements must also be satisfied—such as notice, time of payment, and the amount of cash that must be paid currently. But, basically, without patron consent, distributions of patronage refunds by cooperatives would not qualify for deduction under the law.

If patrons give their consent in writing to the inclusion of the face amount of their patronage refunds in their incomes,[197] or if there is a provision in the bylaws of the cooperative clearly indicating that membership in the cooperative represents consent to such treatment, patronage refunds are

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[193]See "Tax on Cooperatives," p. 430.

[194]See "Tax on Patrons," p. 438.

[195]Int. Rev. Code of 1954, §§ 1381 through 1388.

[196]Int. Rev. Code of 1954, § 1388.

[197]At the patron level, certain amounts are specifically excludable by statute or regulations such as amounts paid or allocated to patrons on the basis of personal, rather than business, expense items. Int. Rev. Code of 1954, § 1385(b)(2).

treated as income to the patrons in the year in which the patronage refunds are made. This means that a cooperative is allowed a deduction for a patronage refund when made, *only when the refund qualifies for the specified treatment at that time in the hands of the patron.* Otherwise, the amount involved is deductible by the cooperative and taxable to the patron only at the time the patronage refund is paid in cash.[198]

Meaning of Certain Terms

Cooperatives have a language of their own in certain business and operational areas. The tax field is no exception. This leads to some misunderstanding by people in other fields who are not familiar with the meaning of specific cooperative-oriented terms. The following paragraphs explain the meaning given to a few of these terms. Also included are some of the special words and phrases subchapter T adds to the basic cooperative vocabulary.

A *cooperative* is a business organization formed for the purpose of providing goods or services for its patron-owners or marketing their products. Not all cooperatives are farmer cooperatives, there being a number of other types, such as mutual fire or life insurance associations, urban consumer cooperatives, electric and telephone cooperatives, wholesaling businesses owned by retailers, and the like.

The term *patron* usually includes any person with whom or for whom a cooperative does business on a cooperative basis, whether a stockholder, member or nonmember of the cooperative, and whether a natural person, firm, corporation, or association.

A *patronage dividend* (cooperatives prefer and normally use the term *patronage refund*) is defined in section 1388(a) of the Code to mean an amount paid to a patron by a cooperative: (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of the cooperative to pay such amount which obligation existed before the cooperative received the amount so paid, and (3) which is determined by reference to the "net earnings" of the cooperative from business done with or for its patrons.

The last sentence of section 1388(a) provides that a patron-

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[198]S. Rep. No. 1707 (on H.R. 13103), 89th Cong., 2d sess. 70 (1966).

age refund shall not include amounts paid (a) out of earnings other than from business done with or for patrons, or (b) out of earnings from business done with or for other patrons to whom no patronage refunds are paid or to whom smaller amounts are paid, with respect to substantially identical transactions.

The regulations,[199] in discussing item (2) above, use the term *valid enforceable written obligation.* It is then explained that an amount is paid "under a valid enforceable written obligation" if the payment is required by State law, or is paid pursuant to provisions of the bylaws, articles of incorporation, or other written contract whereby the organization is obligated to make such payment.[200]

Net earnings, for purposes of item (3) above include the excess of amounts held (or assessed) by a cooperative to cover expenses or other items over the amount of such expenses or other items.[201] The regulations also provide that "net earnings" shall not be reduced by any income taxes imposed by subtitle A of the Code, but shall be reduced by dividends paid on capital stock or other proprietary capital interests.

A *written notice of allocation* means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the patron the stated dollar amount allocated to him on the books of the cooperative, and the portion thereof, if any, which constitutes a patronage refund. A credit to the account of a patron on the cooperative's books without disclosure to the patron, is not a written notice of allocation. The written notice may show the patronage refund as a dollar amount or as a percentage of the stated dollar amount of the allocation notice.[202]

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[199]Treas. Reg. § 1.1388-1(a).

[200]This "written" obligation requirement of the regulations seems to be at odds with certain court decisions. *Farmers' Elevator Co. of East Grand Forks, Minnesota,* T.C. Memo 1962-204 (Dkt. No. 85149), and *Georgetown Farmers Elevator Co.* v. *United States,* 8 AFTR 2d 5549 (D. Minn. 1961), *appeal dismissed on Government's motion,* 305 F. 2d 376 (8th Cir. 1962). These cases hold that an "oral" contract is a sufficient antecedent legal obligation. See also text at footnote 35, in this section.

[201]Treas. Reg. § 1.1388-1(a)(1)(iii).

[202]Treas. Reg. § 1.1388-1(b). But receipts for purchases given to mem-

A *qualified written notice of allocation*[203] is a written notice of allocation which the patron can redeem in cash at face value within 90 days after the date of notice, or a written notice which the patron has consented to include in his taxable income upon receipt in the same manner as cash. A written notice will not qualify as a "qualified" notice unless it is distributed as part of a patronage refund together with *at least 20 percent or more*[204] of the amount of the refund in money or a qualified check as defined in section 1388 (c) (4) of the Code. All other written notices of allocation are "nonqualified."

The *payment period* for a cooperative is the period beginning with the first day of the cooperative's taxable year and ending on the 15th day of the ninth month following the close of such year.[205] For example, the payment period for the taxable year 1972 for a cooperative keeping its books on a calendar year basis would be January 1, 1972 through September 15, 1973.

Patron *consent* to include the full face value of a written notice of allocation in the patron's taxable income may take any of three forms:

1. It may be by individual written consent which must originally be given to the cooperative before the end of the year in which the patronage occurs. It applies to all patronage in that year and subsequent taxable years until revoked in writing. No special form is necessary so long as the terms of the consent are clear. It may be on a signed invoice, sales slip, delivery ticket, marketing contract, or other paper on which the consent appears.

2. For members of a cooperative, consent may be given by becoming or continuing as a member after the co-

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bers together with financial statements distributed at annual meetings did not qualify as "written notices of allocation." *Seiners Association,* 58 T.C. 949 (1972).

[203]Int. Rev. Code of 1954, § 1388(c).

[204]The congressional purpose behind the 20 percent cash requirement was to emphasize to the patrons the taxability of the full amount of the refund in the patrons' hands and to provide the patrons with some cash with which to pay the tax. S. Rep. No. 1881, 87th Cong., 2d sess., 112 (1962), Report of the Committee on Finance on the Revenue Act of 1962.

[205]Int. Rev. Code of 1954, § 1382 (d); Treas. Reg. § 1.1382-4.

operative has adopted (after October 16, 1962) a bylaw provision stating that membership in the cooperative constitutes such consent. This is called "bylaw consent" and takes effect only after the member has received a copy of the bylaw together with a written statement as to its significance. The written statement or notification must be given separately to each member (or prospective member) before patronage occurs. It is not effective after a patron ceases to be a member or after repeal of the bylaw provision.

3. Where neither (1) nor (2) applies, consent may be obtained by a patron endorsing and cashing a *qualified check* or other instrument redeemable in money representing at least 20 percent of the total patronage refund on or before a prescribed date, but no later than 90 days after the close of the payment period, provided such check or instrument has clearly imprinted on it that endorsing and cashing it will constitute such consent.

Tax on Cooperatives

Farmer cooperatives, including those that qualify under section 521 of the Internal Revenue Code, are subject to income tax. Their income and expenses for income tax purposes are computed in the same manner as those of other business corporations. Because they are cooperatives operating under strict rules prescribed by law, they may deduct from gross income certain patronage allocations.

The requirements surrounding these allocations by cooperatives and their distribution to patrons are set out in subchapter T of the Code.[206] Any corporation operating on a cooperative basis is accorded the same treatment[207] with respect to patronage distributions.[208] By and large what a co-

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[206]Int. Rev. Code of 1954, §§ 1382, 1383, and 1388.

[207]Int. Rev. Code of 1954, § 1381(a)(2). Rev. Rul. 70-481, 1970-2 Cum. Bull. 170. See also Rev. Rul. 66-98, 1966-1 Cum. Bull. 200 (department stores formed an association to supply working capital needs of members at cost—held to be operating "on a cooperative basis"), and footnote 30, in this section, and accompanying text.

[208]Rev. Rul. 70-481, 1970-2 Cum. Bull. 170; Rev. Rul. 69-389, 1969-2 Cum. Bull. 166. See also Rev. Rul. 66-380, 1966-2 Cum. Bull. 359, discussed on p. 433.

operative can do with patronage allocations taxwise depends upon how the patrons have consented to be taxed. Thus, the amounts to be included in a patron's gross income are also spelled out in detail.[209]

Subchapter T does not apply to all corporations operating on a cooperative basis. For example it does not apply to exempt mutual ditch, irrigation, or electric or telephone cooperatives, to mutual savings banks, building and loan associations, and the like, or to mutual insurance companies. It also does not apply to taxable organizations which are engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.[210] These organizations are taxed in accordance with the rules of law in effect prior to the effective date of subchapter T.[211]

How can patronage allocations be used to reduce a cooperative's taxable income? They are, according to the law, not to be taken into account in determining the taxable income of a cooperative if paid in money, qualified written notices of allocation, or other property (except nonqualified allocations). The amounts thus "not taken into account" by a cooperative and therefore not taxable to it, must be included in the income of the patron for tax purposes, if the amounts arise from business activity of the patron.[212]

If these conditions are not met, the patronage allocations are "nonqualified" and must be included in the cooperative's taxable income for the year issued. The patron need not include

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[209]Int. Rev. Code of 1954, § 1385.

[210]Int. Rev. Code of 1954, § 1381(a)(2)(A), (B) and (C).

[211]S. Rep. No. 1881, 87th Cong., 2d sess. 113 (1962), Report of the Committee on Finance on the Revenue Act of 1962. See "Electric and Telephone Cooperatives," at p. 458.

[212]Int. Rev. Code of 1954, §1382(b). The last sentence of section 1382(b) states that "any amount not taken into account" under this section shall, in the case of patronage refunds, "be treated in the same manner as an item of gross income and as a deduction therefrom" and in the case of per-unit retains, "be treated as a deduction in arriving at gross income." In either case, however, the "exclusion" or "deduction" at the cooperative level depends in the final analysis on how the patron-taxpayer is willing to handle the amount involved in his tax returns. Per-unit retains are discussed at p. 443.

Amounts received on a patronage basis from a bank for cooperatives by a cooperative and allocated and paid to its patrons, qualify as patronage refunds under section 1382(b) of the Code. Rev. Rul. 69-576, 1969-2 Cum. Bull. 166. For the tax treatment of patronage refunds received by a produc-

nonqualified allocations in income until redeemed, sold, or otherwise disposed of. A deduction may be taken by the cooperative for the amount of nonqualified allocations only when they are redeemed in cash or merchandise. If at that time the cooperative is not able to make use of a deduction, it may obtain a refund with respect to the taxes paid on this amount in the year the nonqualified allocation was made. The patron is required to take redemptions of nonqualified allocations into his income in the year redeemed—again provided such allocations arise out of the patron's business activity and not out of purchases of personal, living, or family items. Sale or other disposition of nonqualified allocations by the patron would also affect the patron's taxable income.

All cooperatives, including those with section 521 status, are allowed 8½ months *after* the close of their taxable years beginning after December 31, 1962, in which to make their patronage allocations.[213]

Farmer cooperatives qualifying under section 521[214] follow these same rules in determining taxable income. In addition, the law provides a deduction by such cooperatives for (1) amounts paid out as dividends on their capital stock and (2) amounts of nonpatronage income paid to patrons on a patronage basis in money, qualified written notices of allocation or other property (except nonqualified allocations).[215] Nonpatronage income includes amounts received from business done with or for the U.S. Government or from nonpatronage sources such as investments. Here, too, the receipt by the patron of

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tion credit association from an exempt cooperative Federal intermediate credit bank see Rev. Rul. 71-556, 1971-2 Cum. Bull. 79 (the bank's class B stock is included at its fair market value); Rev. Rul. 71-557, 1971-2 Cum. Bull. 80; and Rev. Rul. 71-558, 1971-2 Cum. Bull. 81 (written notifications of reserve allocations by the bank and its participation certificates are considered not to have any fair market value, unless clearly established to the contrary).

[213]Prior law extended this 8½-month period to section 521 cooperatives only. Moreover, there was no requirement that the patronage must have occurred in the preceeding taxable year as is now the case under subchapter T except for pooling arrangements. Int. Rev. Code of 1954, §1382 (d) and (e).

[214]See "Requirements for 521 Status," p. 384.

[215]Int. Rev. Code of 1954, §1382(c). See Rev. Rul. 69-621, 1969-2 Cum. Bull. 167 (dividends on stock *actually paid*); Rev. Rul. 70-233, 1970-1 Cum. Bull. 180 (deduction allowed for dividends on stock for year cooperative

dividends on capital stock obligates the patron to include the amount received in his income for the year in which received. Since the current deductibility by the cooperative of allocations to patrons of nonpatronage income, including income from business done with or for the Government, depends upon the "qualified" status of the allocation, the patron need not pick up the amount currently in his income unless it is qualified.

A section 521 cooperative might make patronage allocations in nonqualified form. If it does, the cooperative gets no current deduction. Again, the patron need not report as income the amount of a nonqualified allocation until redeemed, sold, or otherwise disposed of.

Operating on a cooperative basis is essential to tax treatment under subchapter T.[216] Not all arrangements or operating practices satisfy the requirement. For example, the Court of Appeals in affirming the lower court said,[217] "We* * * cannot sanction a masquerade wherein a dividend is costumed in the habiliments of a patronage dividend." The arrangement in question was characterized by the court as a "cooperative camouflage" in that the shareholders were not patrons of the cooperative or users of its cement. They were instead investors in a corporation selling cement to the general public. The distributions to them were not therefore patronage refunds under subchapter T but rather dividends on shares of stock.

In Revenue Ruling 66-380[218] the question was whether a producer-patron who bought crops marketed by his cooperative for other producers was a person with whom the cooperative did business "on a cooperative basis" within the meaning of subchapter T, and whether a patronage refund paid on such

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had section 521 status although dividends were declared in prior year before 521 status established). See footnote 33 in this section.

[216]Int. Rev. Code of 1954, §1381(a)(2); Rev. Rul. 70-481, 1970-2 Cum. Bull. 170.

[217]*Mississippi Valley Portland Cement Co.* v. *United States,* 408 F. 2d 827 (5th Cir. 1969), *affirming* 280 F. Supp. 393 (S.D. Miss. 1967). See also *Etter Grain Co.* v. *United States*, 462 F. 2d 259 (5th Cir. 1972), *affirming* 331 F. Supp. 283 (N.D. Tex. 1971); footnote 146 in this section; and "Introduction," footnotes 24 and 33.

[218]1966-2 Cum. Bull. 359, distinguished in Rev. Rul. 72-547, 1972-2 Cum. Bull. 511, but see T.I.R. 1208, October 20, 1972. Also on the question of "operating on a cooperative basis," see Rev. Rul. 72-602, 1972-2 Cum. Bull. 510, holding that a "nonexempt" cooperative may qualify for subchapter T

purchases was deductible. The cooperative did not have section 521 status. The ruling holds that the "producer-patron" by buying crops marketed by the cooperative placed himself in the same position as a commercial customer to whom the cooperative markets its patrons' products. In the circumstances, the purchaser of the crops in question was said not to be dealing with the cooperative "on a cooperative basis" and he was not therefore considered a patron within the meaning of Treasury Regulation 1.1388-1(e). No patronage refund deduction was allowed.

Revenue Ruling 66-380 is distinguished in Revenue Ruling 72-547, 1972-2 Cum. Bull. 511, where the Internal Revenue Service describes the circumstances under which the combined marketing and purchasing activities of a farmer cooperative that does not have section 521 status will not preclude the cooperative from deducting patronage refunds paid to both marketing and purchasing patrons of the "same" grain. Technical Information Release 1208, dated October 20, 1972, announcing and quoting Revenue Ruling 72-547, cautions that since it is anticipated that the subject matter in the ruling will be covered in regulations to be promulgated, the position reflected in the ruling may be subject to change.

In another ruling under subchapter T[219] it was held that a wholesale grocery cooperative was entitled to a deduction for patronage refunds paid to its independently operated wholly owned subsidiary where it dealt with the subsidiary on a cooperative basis in the same manner as with its other retail grocer members.

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treatment, even though nonmembers outnumber members, if the value of business done with members is more than 50 percent of its total business. Rev. Rul. 72-602 also clarifies Rev. Rul. 68-228, 1968-1 Cum. Bull. 385 (see footnote 31 in this section), so that the example of a cooperative that does 50 percent of its business with members and 50 percent with nonmembers is not taken as the expression of a rule as to the amount of nonmember business a "nonexempt" cooperative may have. Rev. Rul. 68-228 is thus modified by Rev. Rul. 72-602 to the extent that it implies that a "nonexempt" cooperative that deals with nonmembers at a "profit" may do 50 percent or less of its business with members and still qualify under subchapter T of the Code.

[219]Rev. Rul. 69-389, 1969-2 Cum. Bull. 166. See also Rev. Rul. 66-98, 1966-1 Cum. Bull. 200, footnote 207 in this section; Rev. Rul. 70-481, 1970-2 Cum. Bull. 170.

The subsidiary was considered to be a *bona fide* patron of the cooperative. The refunds constitute patronage refunds within the meaning of section 1388 of the Code for which the cooperative was entitled to a deduction under section 1382 of the Code.

How to "Qualify" Patronage Refunds

For patronage refunds to "qualify" under the law and thereby become currently deductible as "qualified written notices of allocation," a cooperative must pay 20 percent of the refund in money or a "qualified check." In addition, one of two other conditions must be met. The patron must either have the opportunity to draw down the total refund in cash within 90 days after the allocation is made, or consent in one of three forms, to have the refund treated as constructively distributed to him and reinvested by him in the cooperative.[220]

With respect to patron consent, a cooperative's patrons must agree "to take into account" at the stated dollar or face amount all written notices of allocation issued to them. A patron, in other words, must agree to include currently in his gross income as ordinary income the face amount of his patronage refunds. He may do this by—

1. agreeing in writing,

2. joining or continuing as a member of a cooperative having a bylaw adopted after October 16, 1962, providing that membership in the cooperative constitutes such consent and after he has received a written notification and copy of the bylaw,[221] or

3. endorsing and cashing a qualified check. This may be done by either members, nonmembers, or both, but this

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[220]The Senate Finance Committee expresses patron consent in terms of a constructive receipt theory. S. Rep. No. 1881, *supra*, footnote 211 in this section, at 114. However expressed, the basic ingredient in any form of consent is the patron's willingness to finance his cooperative. This is one of the reasons he agrees to take the full face amount of the refund into account in his gross income currently.

[221]See text, *infra*, at p. 437 for form of bylaw consent and notification requirements.

is unnecessary if either of the other two forms of consent are obtained. For example, suppose a cooperative gives a patron a check representing a portion of the patron's total patronage refund.[222] This check—and this would also apply to any other instrument redeemable in money—must have clearly imprinted on it a statement that its endorsement and cashing constitutes the consent of the patron to include the full stated dollar amount of the total patronage allocation, referred to in the check, in his income, to the extent required by the Federal income tax laws.

For the noncash portion of the allocation accompanying the qualified check to be treated as a qualified allocation, the check itself must be cashed not later than 90 days after the payment period of the cooperative for patronage refunds (that is, 90 days after September 15 in the case of a calendar year cooperative). However, this is not intended to deny the cooperative the right, to issue qualified checks substantially before the end of the payment period and require cashing within a 90-day period thereafter. Thus, if a cooperative wants to, it may require cashing of such checks before the expiration of its payment period.

By any of the three forms of consent described above, a patron in effect acknowledges constructive receipt of the entire amount of his patronage refund and voluntarily reinvests the amount of the noncash portion of the allocation in the cooperative.

Of course, if an allocation is not a qualified allocation because one of the conditions set forth above has not been met, it must be included in the income of the cooperative in the year issued, with a deduction being taken for this amount by the cooperative only when the nonqualified allocation is finally redeemed in cash or merchandise. If at that time the cooperative is not able to make use of a deduction, a refund may be obtained with respect to the taxes paid on this amount in the year the allocation was issued.

To be effective, individual written consent must be given to the cooperative before the end of the taxable year in which the

[222]A qualified check may also be used as a part of a patronage refund which includes the proceeds of business done with the United States (or any of its agencies) or from sources other than patronage.

patronage occurs. No particular form is required so long as the paper on which it appears clearly discloses the terms of the consent.[223] The paper might be an invoice, sales slip, delivery ticket, or marketing contract. Unless provision is made to the contrary, the written consent applies to all patronage during the year in which received by the cooperative, and, unless revoked, for all subsequent years.

With respect to pooling arrangements, written consent made at any time before the close of the cooperative's taxable year during which the pool closes is effective for all patronage under the pool.[224]

The statute and the regulations[225] require that a patron consenting by means of a bylaw be given "a written notification and copy of such bylaw." The regulations amplify this by stating that the written notification must inform the patron that the bylaw has been adopted and of its significance. Furthermore, this notification and bylaw copy to be effective consent, must be given separately to each member (or prospective member) before patronage occurs. According to the regulations, a prospective member must receive the notification and a copy of the bylaw before he becomes a member.

The regulations also state that a written notice and copy of the bylaw published in a newspaper or posted at the cooperative's place of business would not be sufficient to qualify a written notice of allocation. A member or prospective member is presumed to have received the notification and bylaw copy if they were sent to his last known address by ordinary mail.

Form of Bylaw Consent

The following is an example of a bylaw provision which the

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[223]Neither the congressional committees nor the regulations under subchapter T suggest a form of individual consent. See p. 438 for form of bylaw consent.

[224]See "Capital Retains—Pooling Arrangements," p. 448.

[225]Int. Rev. Code of 1954, §1388(c)(2); Treas. Reg. §1.1388-1(c). See Rev. Rul. 73-93, 1973-1 Cum. Bull. 292, holding that a written notice of allocation made to the estate of a deceased member for business conducted with the cooperative for that portion of the year prior to his death is deductible by the cooperative in arriving at its taxable income, and the estate is required to include the noncash allocation in its gross income. But, if the cooperative wanted to deduct additional written notices of allocation in

Senate Finance Committee stated would meet the bylaw consent requirement:

> Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after———, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.[226]

Revoking Consent

Individual written consent by a patron may be revoked at any time. The revocation must be in writing and furnished to the cooperative. It would be effective only with respect to patronage occurring after the close of the cooperative's taxable year during which the revocation is filed with the cooperative.

In a pooling arrangement,[227] the revocation would not be effective with respect to any products delivered by the patron to his cooperative before he revokes his individual consent.

Bylaw consent continues as long as the patron is a member. If a patron terminates his membership, the bylaw consent applies only to patronage occurring while the patron was a member. Bylaw consent, of course, would not apply after the consent provision is repealed.

Tax on Patrons

The taxation of a patron's income from a cooperative de-

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arriving at its taxable income with respect to the deceased member's estate, the estate would be required to follow the normal procedures for membership which require that the estate receive a copy of the bylaws and sign the application for membership signifying the receipt of the bylaws as required by section 1388 of the Code.

[226]S. Rep. No. 1881, *supra.* footnote 211, in this section, at 318. Treas. Reg. §1.1388-1(c)(3)(ii)(b) uses the same example.

[227]See also "Capital Retains—Pooling Arrangements," p. 448.

pends on several factors such as the type of distribution he receives and the deductibility by the cooperative of the amount distributed which includes the important element of the patron's consent to be taxed. Generally, the patron is not taxed currently on amounts received from a cooperative, unless the distributions are made in strict accordance with the statute and regulations thereby making them deductible by the cooperative.[228]

There are two possible exceptions to this. First, distributions representing dividends on capital would be taxable to the patron even without the statutory consent required in the case of patronage distributions and even though not deductible by the cooperative.[229] Second, the consenting patron is taxed on a patronage distribution even though the cooperative cannot deduct it because it was not distributed in the proper payment period.[230]

Assuming that patronage distributions are appropriately made, the patron is taxed on them in the following manner:

1. Patronage Refunds —

When received as patronage refunds, the patron is generally taxed on the amount of money, the fair market value of property, the stated dollar amount of qualified written notices of allocation, and the total amount of a qualified check (sometimes called a consent check) endorsed and cashed by him. The patron may, however, exclude from his income those patronage refunds based on his purchases of living, or family items.[231]

In the case of section 521 cooperatives, patronage refunds

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[228]Int. Rev. Code of 1954, § 1385(a). See Rev. Rul. 73-93, 1973-1 Cum. Bull. 292, discussed at footnote 225 in this section.

[229]Dividends on capital are not deductible by a farmer cooperative unless it qualifies under section 521. Other cooperatives get no deduction for dividends paid on stock. Of course, advances received by cash basis growers from a cooperative for crops sold to the cooperative are partial payments includable in the growers' gross income in the year received and are not patronage distributions. See Rev. Rul. 71-430, 1971-2 Cum. Bull. 219; I.T. 2107 superseded.

[230]Treas. Reg. §1.1385-1(a)(2).

[231]Int. Rev. Code of 1954, §§1385(b), 1388(e). See also Revenue Rulings cited in footnote 212 in this section.

might include nonpatronage distributions consisting of amounts allocated to patrons on a patronage basis from nonpatronage sources such as interest received from investments and from business done with the United States or its agencies. The portion of a patronage refund representing such distributions received in other property (except nonqualified allocations) also must be included by the patron in his gross income for the year received.

If a patron is not advised in writing of his right of redemption at the time he receives a written notice of allocation, or if he receives less than 20 percent of the patronage refund in cash, the notice is nonqualified. In this situation, the cash received is includable in income in the year received. The balance of the patronage refund covered by the notice would be taxable to the patron in the year the notice is redeemed.[232]

A nonqualified written notice of allocation is not includable in the patron's income in the year it is received. It is included in the year the notice is redeemed or sold. In general, for the purpose of determining the amount of gain from the sale or redemption of nonqualified written notices of allocation, the allocation has a zero basis to the patron.

The regulations under section 1385[233] of the Code deal extensively with questions of gain and loss on sale or redemption of qualified and nonqualified patronage refunds, including appropriate treatment of refunds received with respect to marketing or purchasing of capital assets and depreciable property used in a trade or business. For the most part, these are matters beyond the scope of this text.

Revenue Ruling 70-64 holds that redemption of a qualified written notice of allocation at less than the stated dollar amount entitles the patron-member of a farmer cooperative to an ordinary loss deduction in the year of redemption.[234]

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[232]Here again the patron excludes from his income patronage refunds based on his purchases of living or family items. Int. Rev. Code of 1954, §1385(b)(2).

[233]Treas. Reg. §1.1385-1.

[234]1970-1 Cum. Bull. 36. In *Tomlinson* v. *Massey,* 308 F. 2d 168 (5th Cir. 1962), a patron who sold his revolving fund certificates in 1949, receiving an installment payment thereon in 1951, could report as *capital gain* and not ordinary income, the amount received under the law and

For many years the taxpayer, a chicken farmer, had been a member of the cooperative where he marketed his eggs and chickens and purchased his farm supplies. The cooperative issued qualified written notices of allocation within the meaning of section 1388 of the Code and normally followed the practice of redeeming these allocations for cash as soon as feasible, usually within 1 or 2 years.

In 1963 the member received qualified allocations which he included as ordinary income for the taxable year 1963 at their stated dollar amount in accordance with section 1385(a)(1) of the Code.

In 1968 the cooperative announced for the first time that it would redeem the notices in question for less than their stated dollar amount. Presumably, although the ruling does not so state, the amount paid in 1968 was all the farmers holding 1963 allocations would receive in *redemption* thereof. This would not seem to be the usual situation, since cooperatives normally redeem the full face amount of their allocations, even though for financial reasons such redemptions may be spread over several years.[235]

There is no indication in the ruling as to how the interests of such a member would be affected on dissolution or liquidation of the cooperative. The question presented was whether the taxpayer incurred an ordinary loss or a capital loss.

The ruling holds that since the member joined the cooperative to facilitate his farming business, the notice of allocation arose in the ordinary course of the taxpayer's trade or business. When he received less than the stated dollar amount of the allocation in 1968 he incurred an ordinary loss for that

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regulations then in effect. The Government had, in 1947, levied income taxes on funds held by the cooperative which were represented by the certificates. The parties had stipulated that the certificates, when issued, represented risk capital of the cooperative and no subsequent corporate event changed their character.

Redemption of pre-1963 retain certificates held taxable as long-term capital gains and not as ordinary income. *Raley* v. *United States,* 72-2 USTC ¶9739 (M.D. Fla. 1972), *affirmed in part, reversed and remanded in part,* 491 F. 2d 136 (5th Cir. 1974). See also *Greenvine Corporation,* 40 T.C. 926 (1963); *R. H. Roussey,* T.C. Memo. 1963-254, 22 TCM 1263 (1963).

[235]But see Rev. Rul. 70-407, 1970-2 Cum. Bull. 52, holding that patrons notified in writing by a farmer cooperative that their outstanding patronage credits had been canceled to offset excessive marketing advances paid them in a prior year were entitled to an *ordinary loss* for the year

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year deductible under section 165 of the Code. The loss is measured by the difference between the stated amount included in income in 1963 and the amount received upon redemption.

2. Per-Unit Retain Allocations —

The amount of a per-unit retain allocation made in the form of a qualified per-unit retain certificate during the patron's taxable year is includable in his income in the year received.[236] A nonqualified certificate is not includable in the patron's gross income until redeemed or sold.

The Senate Finance Committee[237] sums up the taxation of patrons under subchapter T pointing out that, with the exceptions noted, a patron is required to take into income the patronage refunds (and nonpatronage distributions) made in cash, qualified allocations, or other property, and the amount he is required to take into his income is the same as that currently deductible or excluded by the cooperative; namely, the stated dollar amount of qualified allocations and the fair market value of other property (except nonqualified allocations). It is noted that the patron is also required to include in his income nonqualified allocations when redeemed.

"Generally," according to the Committee, "the effect of the treatment specified above for patrons taken together with that also outlined above for cooperatives is to obtain a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron. However, this rule will not apply in the case of patronage dividends paid with respect to purchases of personal, living, or family items. In such cases, there is to be no inclusion in the income of the patron with respect to the patronage dividends even though they are not taken into account by the cooperative. This is in accord with the concept that patronage dividends represent price adjustments. Therefore, the patronage dividends in these cases represent downward price adjustments of personal, living, or family items and should no more lead to taxable income than bargain purchases of such items elsewhere.

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in which notified. The patrons had included the patronage credits in gross income in the year received as "qualified written notices of allocation."

[236]See "Capital Retains" p. 443.

[237]S. Rep. No. 1881, *supra*, footnote 211, this section, at 115-116.

"An exception to the rule for inclusion of the patronage dividends in income is also made for patronage dividends attributable to purchases of depreciable property or capital assets. In such cases the patron is not required to take the dividend into income since it in effect represents an adjustment in the price paid for these articles and therefore is reflected in their basis. However, the lower basis for the property in the case of depreciable property will mean smaller depreciation deductions or in the case of capital assets (and depreciable assets) will result in a larger gain upon sale."

Capital Retains

The 1966 amendments of the tax law[238] affecting cooperatives and their patrons apply directly to cooperatives that market products for their patrons and use per-unit capital retain financing. These changes were designed to collect income taxes currently at either the cooperative or patron level on amounts patrons furnish as capital on the basis of the dollar value or the physical volume of products marketed through the cooperative.

Per-Unit Capital Retains—What Are They?

One of the principal responsibilities of membership in a cooperative is to provide funds for capital purposes.

These funds are supplied by members generally to finance the acquisition of assets—current, fixed, and other. In accounting parlance these amounts are reflected as a part of net worth.

The term "retains" is unfortunate because it carries the connotation that the cooperative is "withholding" money or funds from its patrons—perhaps arbitrarily. This, of course, is not the case. These funds are provided by patrons under specific agreements with the cooperative and are, in fact, capital *investments.*

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[238]Section 211, Foreign Investors Tax Act of 1966, Pub. L. 89-809, approved November 13, 1966, entitled Tax Treatment of Per-Unit Retain Allocations, amending subchapter T of the Internal Revenue Code of 1954 (sections 1382, 1383, 1385 and 1388) and section 6044 of the Code relating to information reporting.

Members usually have several alternative methods of meeting their basic financing responsibility. They may make out-of-pocket investments—buy a membership or additional shares of stock, for example. They may invest a portion of their patronage refunds arising from the operations of the cooperative. Or they may furnish capital based on the dollar value or physical volume of products marketed through their cooperative.

It is this latter method of capital financing that brought into use the misleading terms "per-unit retains" and "per-unit retain certificates." The 1966 amendments to subchapter T pick up this unfortunate terminology.

Cooperatives follow different practices in timing the issuance of per-unit retain certificates. The certificates may be issued upon delivery of the product or they may not be issued until the product is ultimately sold. And in cases where an aging process is involved—winemaking for example—or, in a pooling arrangement, several years may elapse before the certificates are issued.

Per-unit capital retain financing should be distinguished from other methods of financing. The method most frequently confused with capital retains is one in which patrons authorize the cooperative to deduct a portion of the marketing proceeds on a per-unit basis to pay operating expenses of the cooperative. From an accounting viewpoint, these latter funds comprise the cooperative's primary *income.* After paying all operating expenses, the balance is distributed as patronage refunds.

Patronage refunds have their own special rules for tax treatment under subchapter T. In general, these rules provide that if the patron consents, he is taxed currently; if not, the cooperative pays the tax because it gets no current deduction for patronage refunds.[239]

Marketing contracts sometimes cover both methods of operation but they do not always clearly distinguish between per-unit capital retains and deductions for operating purposes. As indicated, important distinctions exist between the two which should be recognized in accounting and tax treatment. On the one hand, the patron agrees to invest amounts for capital purposes and, on the other, he authorizes amounts

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[239]See pp. 430 through 442, for a discussion of the tax treatment of patronage refunds at both cooperative and patron level.

for operating purposes. It is only the proceeds for the latter type of activity that appropriately belong in the income accounts of the cooperative.

In spite of these distinctions, the 1966 amendments to subchapter T, as well as Treasury's per-unit retain regulations issued in October 1965[240] seem to proceed on the basis that per-unit capital retains are a part of a cooperative's operating accounts and are thereby subject to income tax treatment at the cooperative level.

The 1965 regulations are superseded by the 1966 amendments, but no new regulations had been issued at the time this text was prepared.

Effect of 1966 Law

In adopting the 1966 changes, the Senate Finance Committee noted that the new law provided "tax treatment with respect to per-unit retain certificates which parallels, in general, the tax treatment applicable with respect to patronage dividends."[241] Thus, the 1966 amendments require a cooperative to pay the tax currently unless its per-unit retains are evidenced by certificates that are *qualified* under the law. The patron is required to pay the tax if he gets a "qualified" certificate. The certificate is qualified only if the patron agreed to include in his gross income currently the face amount of the certificate received. If he gets a "nonqualified" certificate, he reports the amount received only when it is redeemed, sold, or otherwise disposed of.

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[240]T.D. 6855, 1965-2 Cum. Bull. 21. For a discussion of these regulations see Neely & Volkin, *Per-Unit Capital Retains—Tax Treatment by Cooperatives and Patrons,* U.S. Dept. Agriculture, Farmer Cooperative Service, Information 51 (1966); Wile, *Taxation of Farmers' Cooperatives and Their Patrons,* 1966 So. Calif. Tax Inst. 449; Mather, *Per-Unit Retain Regulations—A New Course to Chart,* Cooperative Accountant, Summer 1966, 3.

[241]S. Rep. No. 1707 (on H.R. 13103), 89th Cong., 2d sess. 70 (1966). The committee also noted with respect to the 1965 per-unit retain regulations: "By adopting this amendment, your committee does not intend to reflect on the validity of the regulations recently issued by the Treasury Department with respect to per-unit retain certificates, nor does your committee intend to reflect on the deductibility in the past of per-unit retain certificates to cooperatives or the includability in the past of such certificates in the income of patrons."

The 1966 law refers to a per-unit retain as a "per-unit retain allocation." This is defined, in general, as "any allocation" by a cooperative to patrons based on products marketed for them. Such allocations must be fixed without reference to the net earnings of the cooperative.

A "per-unit retain certificate" is defined as a written notice which discloses to the recipient the stated dollar amount of a per-unit retain allocation.

In order to "qualify" its per-unit retain certificates under the law, a cooperative's patrons must agree "to take into account" at the stated dollar amount all per-unit retain certificates issued to them. In other words, a patron must agree to include currently in his gross income as ordinary income the face amount of his retain certificates. He may do this by—

1. agreeing in writing, or
2. joining or continuing as a member of a cooperative having bylaws adopted *after* November 13, 1966, providing that membership in the organization constitutes such agreement and after he has received a written notification and copy of the bylaw.[242]

The patron must give his individual written agreement to the cooperative before the end of the taxable year in which the patronage occurs. The agreement must apply to all products delivered to the cooperative in that year and subsequent taxable years until the consent is revoked.[243]

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[242]In connection with bylaw consent, the 1966 law provides that members must receive a written notification and copy of such bylaw. Cooperatives should be careful to use procedures that will give members the necessary written notification and a bylaw copy before patronage occurs. The law also seems to require that the notice and bylaw be given to the patron before he becomes a member.

[243]The new law does not specifically deny a deduction or exclusion to the cooperative for its qualified per-unit retains should a consenting patron fail to include the face amount of the retain in his gross income currently. In this connection, compare the October 1965 regulations disallowing a cooperative's deduction if a court held a bylaw consent agreement unenforceable against the patron.

Neither the 1966 law nor the Senate Finance Committee Report offer a suggested form of individual consent or a bylaw provision. Cooperatives electing to get members' consent by means of a bylaw might consider the following language:

> Each person who hereafter applies for and is accepted as a member in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent and agree to include in his gross income the stated dollar amount of all per-unit retain certificates received by him in connection with products marketed through the cooperative on and after .....

or,

> Each person who hereafter applies for and is accepted as a member in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any per-unit retain allocations with respect to his patronage occurring after ....., which are made in per-unit retain certificates (as defined in 26 U.S.C. 1388 (g)) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such per-unit retain certificates are received by him.

Instead of separate bylaw provisions on patronage refunds and on per-unit retains, consideration might be given to amending the patronage refund bylaw adopted to meet the requirements of subchapter T. This could be accomplished by adding to the patronage refund bylaw, where appropriate, the words *"per-unit retain allocations,"* and *"per-unit retain certificates."*

Individual written consents under the 1966 law might be as follows:

> I agree to include in my gross income the face amount

of any per-unit retain certificates issued by the cooperative to me on and after .....

Signed.....

Revocation Procedures

Individual written consent by a patron may be revoked at any time. The revocation must be in writing and filed with the cooperative. It would be effective only with respect to products delivered by the patron on or after the first day of the cooperative's first taxable year beginning after the revocation is filed with the cooperative.

In a pooling arrangement, the revocation would not be effective with respect to any products delivered by the patron to the cooperative before he revokes his individual consent.

A bylaw consent cannot be revoked so long as the patron is a member. If a patron terminates his membership, the bylaw consent applies only to per-unit retain certificates issued in connection with products delivered before he ceased to be a member.

Pooling Arrangements

The 1966 law contains several broad provisions relating to pooling arrangements.

Many pooling operations call for the cooperative to account to its producers for their commodities from the time of receipt to final disposition. The identity of the product with the producer generally remains intact and the pool may not be closed until the products are finally disposed of.

At the end of a taxable year, therefore, several pools may still remain open. When the pools are closed, the net sales returns from marketing all members' products within a given group are combined and averaged. The total payment to producers within the group is made on the same basis as all others, after taking into account quality and grade differentials and after deducting advances.

The 1966 law recognizes that *patronage*, or the turning over to a cooperative of products for the purpose of marketing, is considered to take place during the taxable year of the cooperative in which the pool closes. If a pool is closed 2 years after delivery of the product, then patronage is said to

have occurred during the second year, even though actual delivery to the cooperative may have taken place 24 months earlier.

Some cooperatives may want to consider their *marketing* functions as taking place during any of the taxable years a pool is open. The 1966 amendments give cooperatives some flexibility in timing the issuance of retain certificates for products marketed under a pooling arrangement.

If a pool is open 2 years, for example, the cooperative may issue its certificates during a period beginning at any time during the 2-year period the pool is open and ending with the 15th day of the 9th month following the close of the taxable year in which the pool closes. The cooperative gets the deduction or exclusion in the year its qualified certificates are issued.

A technical amendment added to the Tax Reform Act of 1969 by the Senate Finance Committee[244] was approved, according to the Committee's press release of October 17, 1969, "to allow cooperatives 8½ months after the close of the year to make cash payments of per-unit retain allocations and deduct them, thus conforming to the period presently allowable in the case of non-cash allocations."

The Conference Committee approved and explained the change saying that it "provides that a cooperative can deduct or exclude from gross income per unit retain allocations whether they are paid in qualified per unit retain certificates (as under existing law) or whether they are paid in money (or other property)."[245] The enactment of this amendment removes a major problem that confronted cooperatives following the issuance of a series of three revenue rulings[246]

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[244]This amendment became section 911 of the Tax Reform Act of 1969. Pub. L. 91-172, approved December 30, 1969, and changed sections 1382(b)(3) and 1388(f) of the Code. The amendments made by section 911 of the Act apply to per-unit retain allocations made after October 9, 1969. Sec. 911(c) of the Act.

[245]H.R. Rep. No. 91-782, 91st Cong., 1st sess. 336 (1969), Conference Report to Accompany H.R. 13270.

[246]Rev. Rul. 67-333, 1967-2 Cum. Bull. 299 (Oct. 2, 1967); Rev. Rul. 69-67, 1969-1 Cum. Bull. 142 (Feb. 17, 1969); and Rev. Rul. 69-71, 1969-1 Cum. Bull. 207 (Feb. 17, 1969). For an analysis of these rulings see Estes, *The Cooperative Pooling Rulings,* Cooperative Accountant, Summer 1969, 3. See also Rev. Rul. 71-374, 1971-2 Cum. Bull. 320, holding that per-unit retain certificates issued before October 10, 1969, but not re-

on pooling arrangements. These rulings deal, in general, with pools closed before the products are disposed of and the valuation of unsold inventories.

The 1969 change in the law clearly allows a cooperative a deduction for pool sale proceeds undistributed at the end of its tax year but thereafter paid out in cash during the payment period for that year. Cash payments during the statutory payment period would appear to be deductible by the cooperative without the necessity of any bylaw or individual consent agreement from the patrons. There is some question, however, whether the new legislation clears up one of the problems under the rulings—namely, a requirement that unsold inventories be valued at cost.[247]

Effect of Not Qualifying

A cooperative may deliberately choose not to comply with the law or inadvertently fail to do so. In either event, its retain certificates would not qualify and the cooperative might incur a corporate income tax liability. The tax liability would arise because its per-unit retains would not be allowable deductions, exclusions, or "cost of goods sold" items, in computing gross income for Federal income tax purposes.

A deduction is available, however, in the year a "timely issued" nonqualified certificate is redeemed in cash. To be "timely issued" a nonqualified certificate would have to be issued within 8½ months after the close of the cooperative's tax year during which the marketing occurred. If a deduction cannot be utilized in the year redeemed because the cooperative otherwise had no taxable income in that year, a tax refund may be available for the year in which the nonqualified certificate was issued.

A cooperative that relies solely on individual written consent agreements to qualify its retain certificates may sometimes fail to obtain agreements from all patrons. In such a case, the cooperative's current retain deductions for tax purposes would be limited to the face amount of its qualified cer-

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deemed within 30 days of issuance are treated as qualified per-unit retain certificates under section 1388(h) of the Code; but that certificates redeemed within 30 days are treated as a cash advance.

[247]Rev. Rul. 69-67, 1969-1 Cum. Bull. 142.

tificates. As previously indicated, a cooperative gets no current deduction when it issues nonqualified certificates.

Validity of Existing Consents

Many cooperatives obtained individual written consents or adopted bylaw provisions to comply with Treasury's October 1965 regulations. Enactment of the 1966 amendments raised questions as to what action, if any, they needed to take to comply with the new law.

Written Consents.—A written consent agreement obtained under the October 1965 regulations would continue in effect and no new agreement would be necessary if the following conditions were met:

1. The agreement clearly provided that the patron agreed to treat the stated dollar amount of all per-unit retain certificates issued to him as cash distributions which he had reinvested in the cooperative. (The October 1965 regulations called for an individual consent expressed in these terms.)
2. The patron could revoke the written agreement at any time after the close of the taxable year in which it was made.
3. It was effective during the period between October 15, 1965 and November 13, 1966.
4. It was effective on November 13, 1966, and the patron had not given the cooperative a written notice of revocation.

Bylaw Consent.—In the case of a bylaw consent agreement adopted under the October 1965 regulations and in effect on November 13, 1966, the 1966 law provides that it will be effective as a basis for issuing qualified per-unit retain certificates only for taxable years of cooperatives that began *before* May 1, 1967.

If a cooperative adopted its bylaw consent under the October 1965 regulations (before November 13, 1966) and its taxable year began on April 1, 1967, the bylaw would be effective through March 31, 1968, as a basis for issuing qualified per-unit retain certificates. Thereafter, a new bylaw would have to be adopted.

Cooperatives having taxable years beginning *on* and *after* May 1, 1967, had to adopt a new bylaw consent provision be-

fore any patronage or marketing occurred as a basis for issuing qualified certificates.

Tax Treatment for Prior Years' Retains

The 1966 law applies to per-unit retains made during taxable years of cooperatives that begin after April 30, 1966. Internal Revenue Service Technical Information Release 775, October 15, 1965, and a subsequent Revenue Procedure[248] provides certain guidelines for the tax treatment of per-unit retain certificates issued with respect to products marketed for patrons during a tax year beginning *before* May 1, 1966.

These guidelines state that the Internal Revenue Service will accept a cooperative's treatment of such per-unit retain certificates if this treatment is consistent with the general principles contained in sections 1.522-1 through 1.522-3 of the Income Tax Regulations, relating to amounts allocated by cooperatives on a patronage basis.

Thus, "pre-May 1, 1966," per-unit retain certificates disclosing to patrons the face amount of retains issued in accordance with a preexisting mandatory agreement and within 8½ months after the close of the taxable year would seem to meet the guidelines. If the cooperative excluded from its gross income or added the face amount of its retain certificates to "its cost of goods sold," the Internal Revenue Service should not object.

Tax treatment of "pre-May 1, 1966," per-unit retains at the patron level was not mentioned in these first guidelines. In Revenue Ruling 68-236,[249] however, the Service makes it clear that with respect to per-unit retain certificates issued in connection with products delivered in taxable years of the cooperative beginning before May 1, 1966, only the fair market value of the certificate at the time of receipt is to be included in the patron's gross income.

If the certificate had no fair market value at the time of receipt, the patron need not include it in gross income for the year received. The patron would report the amount received when the certificate is redeemed, sold, or otherwise disposed of.

[248]Rev. Proc. 66-45, 1966-2 Cum. Bull. 1254.

[249]1968-1 Cum. Bull. 382, based on Technical Information Release 953, dated January 3, 1968.

Summary of Alternatives Available

Cooperatives and their patrons are subject to Federal income taxes. They are not tax exempt as so many seem to believe.

Today's Federal tax law preserves the principle of a single, current tax on income produced through farmers' and other cooperatives, provided they meet these conditions:

- Adhere to strict requirements as to the *form* in which they handle and distribute capital retains and patronage refunds.
- Make distributions within the prescribed time.

In complying with the tax law, a number of alternative choices are available.

CHOICE 1. The recent amendments to the law applying to cooperatives do not repeal or modify in any way the requirements of section 521 of the Internal Revenue Code of 1954 relating to farmer cooperatives. If they can comply with its terms they are entitled to two deductions in addition to those allowed other corporations:

1. Amounts paid as dividends during the taxable year on capital stock (which has been construed to include any form of return on all genuine capital interests).

2. Amounts of nonpatronage income (such as income on business with the United States, rents, and interest) paid on a patronage basis to patrons, if distributed within 8½ months after the year in which they were derived.

Thus, the *first* choice a farmer cooperative has is whether to operate in compliance with the requirements of section 521. If the cooperative does operate under its rigid requirements, it would not have to pay taxes on: (1) The part of its margins devoted to a return on capital interests and (2) the part arising from nonpatronage activities, including business done with or for the United States provided it is allocated to its patrons.

If the cooperative decides not to qualify under the requirements of section 521, the cooperative will pay taxes at regular corporate rates on this part of its net margins even though allocated.

CHOICE 2. The next choice relates to the form and time in which a cooperative pays its patronage refunds. For, to emphasize again it is the *form* and *timing* of refunds which determine their tax treatment under the law, at both the cooperative level and, in the main, at the patron level.

The law lays down precise and strict rules which cooperatives (including farmer cooperatives that qualify under section 521 of the Code) must follow before they may use patronage refunds to reduce their gross income for tax purposes.

First, the refund must meet the definition of a "patronage dividend" set forth in the statute. This means that the refund must be:

1. Computed on the basis of quantity or value of business done with or for the patron;

2. Made pursuant to a preexisting written obligation of the cooperative; and

3. Determined by reference to the "net earnings" of the organization from business done with or for patrons. (This excludes true "capital retains" from sales proceeds. In 1966, however, the law was amended to provide similar treatment for capital retains. In general, these are amounts allocated to patrons *without* reference to "net earnings.")

Second, the refund or capital retain must be paid in cash, property of a kind on which a current value can be placed, or in what the statute calls "qualified written notices of allocation," or, in the case of capital retains, "qualified per-unit retain certificates."

Third, the refund or capital retain must be "paid" within 8½ months following the close of the cooperative's fiscal year. (The statute calls the 12-month fiscal year *plus* this 8½ months period the cooperative's "payment period.")

CHOICE 3. A third choice is in qualifying the "written notices" or "certificates." To be "qualified" they must meet the following requirements:

1. They must be in the form of a document that discloses the *amount* of the allocation and the *portion* thereof which is a patronage refund or capital retain (as compared to distributions of nonpatronage income);

2. At least 20 percent of the patronage refund must be paid in cash. No 20-percent cash payment is required to "qualify" capital retains.

At this juncture, however, the cooperative can choose between making refunds under circumstances in which it has a form of patron's consent, or in a form redeemable in cash by the patron within a period of 90 days following the date of issuance.

CHOICE 4. If the cooperative elects to get a form of patron's consent, it again has choices—three to be exact:

1. *Individual patron's written consent.* This form of consent must be given to the cooperative before the end of the year in which the patronage occurs. It applies to all patronage in that year. It also covers patronage in subsequent taxable years until a written revocation becomes effective.

A revocation of individual written consent is effective only on patronage occurring after the close of the cooperative's taxable year in which it is given.

2. *Bylaw consent.* The patron may consent by obtaining or retaining membership in a cooperative with a bylaw that sets forth the required members' agreement to take qualified written notices of allocation or per-unit retain certificates into account currently in computing their Federal income tax liability.

The bylaw must have been adopted after October 16, 1962 (November 13, 1966, in the case of capital retains), and it must clearly set forth this consent agreement. The consent under this method becomes effective only on patronage occurring after each patron receives a written notification of the adoption of the bylaw that explains its significance. A copy of the bylaw must accompany the notification.

Mailing this material by ordinary mail to the patron's last known address is permitted. New members must have this material *before* becoming members. Termination of membership or repeal of the bylaw terminates this form of consent.

3. *Consent by qualified check.* If neither of the first two methods is used, a patron may consent by endorsing and cashing a check or other instrument redeemable in money that represents at least 20 percent of the total patronage refund, and has clearly imprinted on it that endorsing and cashing it will constitute such consent. (The qualified check consent does not apply to capital retains.)

This endorsement and cashing must take place within 90 days following the end of the cooperative's payment period (see definition previously given) to constitute a valid consent.

This latter method is a "one shot" deal, applying only to the patronage refund of which the check is a part.

CHOICE 5. Implicit in choice 3 is the alternative to pay some or all patronage refunds or capital retains in nonqualified form. A cooperative may deliberately elect to do this simply by failing to comply with one or all of the requirements as to *form* of the allocation. In this event, it may incur a current tax liability, since it gets no current deduction or exclusion. A deduction is available, however, when the nonqualified allocation or per-unit retain certificate is redeemed in cash. If a deduction cannot be utilized, a refund of tax paid is available.

Under the Treasury regulations (28 Fed. Reg. 3152), a section 521 cooperative, without losing its status, has two further choices:

1. It may pay patronage refunds or capital retains of less than $5 in nonqualified form even to consenting members; or

2. If it issues, to nonconsenting patrons, nonqualified patronage allocations or nonqualified per-unit retain certificates which are interest bearing or in the form of dividend paying stock, it may make deductions (reasonable in relation to the fact that it receives no tax benefit on such allocations until redemption) in the interest or dividends paid.

The foregoing summary emphasizes the strict rules that must be followed and, at the same time, shows that there is a certain amount of flexibility in the Code provisions. Cooperatives in considering matters of taxation, as all businesses

must do, have alternative methods of operation under the tax laws. Each cooperative must determine the courses that best fit the particular needs of its members and patrons.

Corporations Organized to Finance Crop Operations

Paragraph (16) of section 501(c) of the Internal Revenue Code of 1954 provides for exemption from Federal income tax of certain corporations[250] set up for the purpose of financing crop operations by organizations which qualify under section 521. It reads as follows:

> (16) Corporations organized by an association subject to part IV of this subchapter or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, on dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

A corporation that financed crop operations of members and other fruit producers did not qualify under this section.[251] It was found by the court that the corporation was not organized by an exempt cooperative or the members thereof. The court said it was clear that the purpose of the paragraph

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[250] As to the tax on "unrelated business income" of exempt organizations, see p. 464.

[251] *Growers Credit Corporation,* 33 T.C. 981 (1960).

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was to extend exempt status to "financial auxiliaries of exempt cooperatives," and for a crop financing corporation to be exempt, "it must be organized by and operated in conjunction with and for the benefit of" an exempt association or its members.

Mutual Insurance Companies or Associations

Farmers' mutual insurance companies or associations meeting the provisions set forth in paragraph (15) of section 501(c) of the Internal Revenue Code of 1954 may qualify for exemption.[252] The paragraph reads as follows:

> (15) Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from the items described in section 822 (b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $150,000.

Revenue Ruling 67-80[253] holds that in determining the gross amount received during the taxable year for the purposes of the limitation provided in section 501(c)(15) of the Code, premiums written or received on insurance contracts during the taxable year are to be taken into account without deduction for amounts paid or incurred for reinsurance or for return premiums.

Electric and Telephone Cooperatives

Section 501(c)(12) of the Internal Revenue Code of 1954 provides exemption from the Federal income tax for "Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and

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[252]As to the tax on "unrelated business income" of exempt organizations, see p. 464.

[253]1967-1 Cum. Bull. 143.

expenses." Electric and telephone cooperatives can qualify under this section and almost all of them do.[254]

Exemption is not automatic. It is recognized by the Internal Revenue Service only after an application (Treasury Department Form 1026) is filed with the appropriate District Director of Internal Revenue.[255] The cooperative is notified by letter whether exemption is recognized and this letter should be preserved. An organization authorized to pay dividends on membership capital would not qualify. Dividends on stock or on the value of other capital equity interests are viewed as a distribution of profits and are not considered an expense within the meaning of the term "losses and expenses." They are also considered to be inconsistent with the requirement that an organization exempt under section 501(c)(12) must operate at cost.[256]

Telephone cooperatives are specifically mentioned in the statute. Electric cooperatives fall within the "like organizations" category.[257] Nonprofit operation is required and assurance that this condition will be met is provided by capital

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[254]Rev. Rul. 67-265, 1967-2 Cum. Bull. 205, superseding I.T. 1671, II-1 Cum. Bull. 158 (1923). An electric cooperative in Tennessee has been held exempt under section 101(8) of the Internal Revenue Code of 1939 (sec. 501(c)(4) of the 1954 Code) as an organization "for the promotion of social welfare." *United States* v. *Pickwick Electric Membership Corporation,* 158 F. 2d 272 (6th Cir. 1946). The Internal Revenue Service does not agree with this decision. Rev. Rul. 57-494, 1957-2 Cum. Bull. 315.

[255]*How to Apply for Recognition of Exemption for an Organization,* Publication 557 (4-73), Internal Revenue Service, U.S. Dept. Treas. (1973). Exemption remains in effect from year to year as long as section 501(c)(12) requirements are met. As to the tax on "unrelated business income" of exempt organizations, see p. 464. See also Rev. Proc. 72-4, 1972-1 Cum. Bull. 706, for discussion of procedure in case of revocation or modification of determination letters and protests of adverse determinations. The cooperative must file the annual information return (Form 990) required of exempt organizations by the 15th day of the 5th month following the close of the fiscal year. See footnotes 87 through 90 in this section with respect to the filing of Form 990 as a return that starts the statute of limitations.

[256]See Part 15(33), *Exempt Organization Handbook*, the publication of the Internal Revenue Service for use of its personnel in connection with their work involving exempt organizations. It may be examined at the IRS National Office in Washington, D.C.

[257]An organization made up of electric cooperatives exempt under section 501(c)(12) to finance purchases of electric, water, or plumbing applicances and systems by consumer-members of the electric cooperatives

credit bylaws[258] used by electric and telephone cooperatives.[259]

These capital credit bylaws spell out the agreement between a cooperative and its patrons that all amounts paid for service in excess of operating costs and expenses of providing the service are furnished as capital. The amounts so furnished are credited to the account of each patron on a patronage basis and he is notified each year of the amount of the credit. Generally, these capital credits are retired in cash on a first-in, first-out basis when, in the judgment of the board of directors, the retirement will not impair the financial condition of the cooperative. As an exception to first-in, first-out retirements, the board has discretion to authorize cash settlements to decedents' estates.[260]

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was not a "like organization" even though it was a nonprofit cooperative since it financed consumer purchases and did not distribute electric energy. *Consumer Credit Rural Electric Cooperative Corp.* v. *Commissioner,* 319 F. 2d 475 (6th Cir. 1963). Also a nonprofit cooperative selling electrical materials, equipment, and supplies and furnishing equipment manufacturing, repairing, testing, and other services to its members was not a "like organization," although its membership was limited to electric cooperatives that qualified under section 501(c)(12). Rev. Rul. 65-201, 1965-2 Cum. Bull. 170.

[258]*Capital Credits—Consumer Benefits*, REA Bull. 102-1, Rural Electrification Administration, U.S. Dept. Agr. (1964). See "Sample Legal Documents" at p. 578 for a bylaw of the capital credits type. See also "Nonprofit Associations" at p. 219.

[259]See *Salt River Project Agricultural Improvement and Power Dist.* v. *Federal Power Commission*, 391 F. 2d 470 (D.C. Cir. 1968), *certiorari denied*, 393 U.S. 857 (1968), where the court noted that electric cooperatives "are non-profit," stating that "Most of them have developed a 'capital credits' plan by which all money over and above that required for operating costs is credited back to the member-owners who paid it in. Consequently neither the cooperative nor any individual can profit from the sale of electricity by the cooperative to its members." In *Consumer Credit Rural Electric Cooperative Corp.* v. *Commissioner,* 319 F. 2d 475 (6th Cir. 1963), the court recognized the bona fides of a capital credits bylaw even though the cooperative failed to qualify under section 501(c)(12) for other reasons. See also Rev. Rul. 70-13, 1970-1 Cum. Bull. 272, for an analysis of the capital credits bylaw.

[260]A bankruptcy court has ruled a bankrupt corporation to be "de facto dead." *In the Matter of Great Plains Royalty Corporation, et al.*, 471 F. 2d 1261 (8th Cir. 1973). Accordingly, reasoned the court, an electric cooperative and a telephone cooperative became obligated to pay capital credits to the "trustee of the bankrupt's estate" pursuant to bylaw pro-

With the advent of supplemental private financing for Rural Electrification Administration borrowers,[261] there are new mortgage provisions relating to capital credit retirements. These provisions establish net worth tests that will facilitate supplemental financing and may delay some cash retirements. They reflect the lenders' determination as to reasonable criteria for helping to assure development of adequate capital. But there is no absolute prohibition against retirements. The restraints are merely temporary—until a certain net worth position is achieved.[262]

The section 501(c)(12) requirement that "85 percent or more of the income" consist of amounts collected from mem-

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visions which gave the boards of directors discretion to retire capital credits "upon the death of any patron." The bankrupt's trustee had sought early retirement of capital credits as a setoff and counterclaim against the cooperatives' claims for unpaid bills for service. The cooperatives had a policy of paying capital credits to the estates of individual patrons who die. This bylaw had never been construed to apply to a dissolved corporation or one that became bankrupt. The cooperatives contended that they had no authority to pay, out of turn, the claims of the trustee of the bankrupt corporation since it, like a bankrupt individual, might again go into business. The court, in what appears to be a questionable decision, ruled against the cooperatives. Other courts may be less inclined to find that this kind of differentiation between individuals and corporations in capital credit retirements is unreasonable and violates what the court here said was a "statutory proscription against discrimination between patrons in the payment of patronage refunds" and a violation of the "policies of general application" requirement of the bylaws. *Cf.* cases, footnote 19. "Revolving-Fund Plan of Financing," *infra;* also see text and cases, footnotes 281, 282 and 283, "Interest in Association," *supra.*

See Rural Electrification Administration Bulletins 102-2 (Electric, 1971) and 402-2 (Telephone, 1960), relating to partial waiver of mortgage provisions on retirements of capital by cooperatives.

[261]With respect to REA loans see "Statutes Providing Credit Facilities" at p. 523.

[262]See talk by Henry E. Freedman, entitled *REA's Current Capital Credits Recommendations,* presented at the Special Tax Conference, National Rural Electric Cooperative Association, Minneapolis, Minn., Dec 1971. See also talk by Louis Gorrin, Special Counsel to NRECA, on *Supplemental Private Financing—Its Varied Impacts on REA Borrowers,* at NRECA Annual Managers' Conference, New Orleans, La., Aug. 1972, for a discussion of changing attitudes over the years with respect to capital credit retirements and current mortgage requirements under supplemental private financing; and his remarks at NRECA Tax Conference, New Orleans, La., Dec. 1972, concerning supplemental private financing and capital credits.

bers has sometimes presented problems.[263] It means, of course, that the sum total of all nonmember income cannot exceed 15 percent in any one tax year.[264]

In 1972, the Internal Revenue Service published a Revenue Ruling explaining certain requirements that cooperatives must meet to qualify under section 501(c)(12).[265] The ruling recognizes that under the regulations[266] excess funds on hand at the end of the year may be retained to meet future losses and expenses, or returned to members. The specific questions considered and their answers are as follows:

Question 1. Should the interests of members in the savings of an organization be determined in proportion to their business with the organization?

Answer: Yes. In accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization. The interests of members in the savings of the organization may be determined in proportion to either the value or the quantity of the services purchased from the organization, provided such basis is realistic in terms of actual cost of the services to the organization.

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[263]A Government agency may be a member of an electric cooperative. Rev. Rul. 68-75, 1968-1 Cum. Bull. 271. See text and cases, footnotes 235 and 236, "Who May Become Members," *supra*. Where the accrual method of accounting is used, compliance with the 85 percent test must be determined by that method. Rev. Rul. 68-18, 1968-1 Cum. Bull. 271. A mutual ditch company lost its exemption when more than 90 percent of its total income in one year consisted of gains from sales of capital assets. *Cate Ditch Co.* v. *United States,* 194 F.Supp. 688 (N.D. Calif. 1961). See *Mountain Water Co. of La Crescenta*, 35 T.C. 418 (1960). An electric cooperative sold its office building on an installment basis and in determining whether it met the 85 percent test, the gain it was required to include in its income from nonmember sources for the annual accounting period involved was the income portion of the installment payments actually received during the period. Rev. Rul. 65-99, 1965-1 Cum. Bull. 242.

[264]A generation and transmission cooperative was required to include, as nonmember income, rents it received from a nonmember power company for use of the cooperative's facilities. Rev. Rul. 65-174, 1965-2 Cum. Bull. 169. A telephone cooperative collecting more than 85 percent of its income from members qualified, even though nonmembers were charged more for service than members. Rev. Rul. 70-130, 1970-1 Cum. Bull. 133.

[265]Rev. Rul. 72-36, 1972-1 Cum. Bull. 151.

[266]Treas. Reg. §1.501(c)(12)-1(a).

Question 2. Can funds be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes?

Answer: Yes. However, such funds may not be accumulated beyond the reasonable needs of the organization's business. Whether there is an improper accumulation of funds depends upon the particular circumstances of each case.

Question 3. Where an organization retains funds for purposes other than meeting current losses and expenses, must the organization's records show each member's rights and interest in the funds it retains?

Answer: Yes. To maintain its mutual or cooperative character an organization must keep such records as are necessary to determine, at any time, each member's rights and interest in the assets of the organization.

Question 4. What is the effect on exemption of a forfeiture of a former member's rights and interest where the bylaws provide for such forfeiture upon withdrawal or termination?

Answer: If, under the bylaws, a member's rights and interest have been forfeited, the organization has not operated on a mutual or cooperative basis and is therefore not exempt.

Question 5. Where, upon dissolution, an organization has gains from the sale of an appreciated asset, how should these gains be distributed?

Answer: Such gains should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by such members during that period, insofar as is practicable.

Of course, electric and telephone cooperatives that do not meet the requirements of section 501(c)(12) are not exempt and are taxable corporations. They file income tax returns[26] and pay taxes on any taxable income. This would include interest income, for example. As indicated previously, though,

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[267]The due date of the return (Form 1120) is the 15th day of the 3d month following the close of the fiscal year.

any amount a cooperative receives from its patrons under an obligation to return to the patrons on the basis of patronage, would be excluded from taxable income.[268] This well-established principle of law was continued without qualification for rural electric and telephone cooperatives when subchapter T was added to the Internal Revenue Code in 1962. Subchapter T expressly does not apply to them, meaning that the pre-1962 law applies.[269]

The question is sometimes asked whether amounts excluded from an electric or telephone cooperative's taxable income are taxable in the hands of their patrons. The answer is "Yes," when received in cash—to the extent the amount paid for service was a business expense. This treatment is consistent with the concept that where service was used for nonbusiness purposes, the refunds to patrons represent "downward price adjustments of personal, living, or family items and should no more lead to taxable income than bargain purchases" of such service elsewhere.[270]

Tax on Unrelated Business Income of Exempt Organizations

The Tax Reform Act of 1969[271] extended the unrelated business income tax[272] to all organizations exempt from the Federal income tax under section 501(a)[273] of the 1954 Code, except United States instrumentalities created and made tax exempt by specific act of Congress. In general, an exempt organization is subject to the tax on unrelated business income only if it regularly carries on trade or business "which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the

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[268]See "Taxation of Nonexempt Cooperatives" at p. 364 and "Nonprofit Associations" at p. 219.

[269]Int. Rev. Code of 1954, §1381(a)(2)(A) and (C). See "Tax on Cooperatives" at p. 430.

[270]S. Rep. No. 1881, 87th Cong., 2d sess. 116 (1962), Report of the Committee on Finance on the Revenue Act of 1962.

[271]Section 121, Pub. L. 91-172, approved December 30, 1969.

[272]Int. Rev. Code of 1954, §§ 511-514.

[273]The section of the Internal Revenue Code providing for exemption from tax on corporations. Subsection (c) of section 501 contains the list of exempt organizations. With respect to organizations described in section 501(c)(4), (7), (8), (9), (10), (11), (12), (13), (14)(A), (15), (16) or (18), the taxes

profits derived)" to the carrying out of the functions constituting the basis for the exemption.[274] The unrelated business taxable income of an organization subject to the tax would include only income derived from such unrelated trade or business as may be regularly carried on by it.[275]

One essential element in the imposition of the tax, namely, that the activity be "not substantially related" to the exempt purpose of the organization, has been described as the "most conceptually difficult of the tests and probably defies complete mastery. The current regulations set out qualitative and quantitative concepts to be used in making the determination. The activity must bear a substantial causal relationship to the achievement of the exempt purposes and *must contribute* importantly to the accomplishment of the exempt purposes in other ways than through the production of income. The scope of the activity must be considered, and where the activity becomes so substantial in its relationship to the exempt function that it amounts to the 'tail wagging the dog,' there will be unrelated business income."[276] Under this concept, it is unlikely that electric or telephone cooperatives would be subject to the tax on unrelated business income. The tax does not apply to a farmer cooperative qualifying under section 521.

A question has been raised as to whether income from directory advertising received by telephone cooperatives exempt under section 501(c)(12) would be subject to the tax on unrelated business income. Revenue Ruling 74-38, I.R.B. 1974-4, 9, holds that income derived by an association of law enforcement officials exempt under section 501(c)(6) of the Code, from sale of space in its journal either for conventional advertising or merely to identify the purchaser of the space without a further advertising message constitutes unrelated trade or business income under section 513 of the Code.

Exempt organizations are required to file annual information returns (Treasury Form 990) on or before the 15th day of the 5th calendar month following the close of the organiza-

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imposed by section 511(a)(1) apply only for taxable years beginning after December 31, 1969. Treas. Reg. § 1.511-2(ii).

[274]Int. Rev. Code of 1954, §513.

[275]Int. Rev. Code of 1954, §512.

[276]Webster, *The Law of Associations*, American Society of Association Executives (1971), p. 279.

tion's fiscal year. If there is any unrelated business income to report, then a Form 990-T must also be filed. But this form, like a regular corporate income tax return, is due on or before the 15th day of the 3d month following the close of the fiscal year. The filing of these returns may start the statute of limitations against assessment of the tax.[277] Normally, the Service has only 3 years from the time a return is filed to determine whether there is any tax liability.

The fact that an unrelated business income tax may be payable by an organization would not mean that it should, or should not, retain its exemption. This is to be determined on the basis of the organization's overall activities without regard to the fact that some of its activities may be subject to the unrelated business income tax.[278]

Deductions By Certain Membership Organizations In Transactions With Members— New IRC Section 277

The Tax Reform Act of 1969[279] added a new section to the Internal Revenue Code of 1954 that will affect some membership organizations not exempt from taxation. The new provision reads:

> In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing

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[277]See footnotes 87 through 90 in this section with respect to the filing of information returns as returns that start the statute of limitations. The filing of Form 990, according to Rev. Rul. 69-247, 1969-1 Cum. Bull. 303, will start the statute of limitations provided sufficient facts are disclosed on the Form 990 to apprise Internal Revenue of the potential existence of unrelated business taxable income. The return must state the nature of the income-producing activity with sufficient specificity to enable the Commissioner to determine whether the income is from an activity related to the organization's exempt purpose and the return must disclose the gross receipts from this activity. In *California Thoroughbred Breeders Association,* 47 T.C. 335 (1966), where no Form 990-T was filed, Form 990 was held sufficient to start the statute.

[278]H.R. Rep. No. 91-782, 91st Cong., 1st sess. 290 (1969), Conference Report to Accompany H.R. 13270.

[279]Pub. L. 91-172, title I, §121(b)(3)(A), approved December 30, 1969.

services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade shows which are primarily for the education of members). If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year.[280]

The purpose of section 277 is to overcome the decision of the Ninth Circuit Court of Appeals in *Anaheim Union Water*[281] and "to prevent membership organizations from escaping tax on business or investment income by using this income to serve its members at less than cost and then deducting the book 'loss.'"[282] The section provides that in the case of certain taxable membership organizations the deduction of expenses incurred in supplying services, facilities, or goods to the members is to be allowed only to the extent of the income received from these members. The effective date of the provision was delayed until January 1, 1971—the additional time being allowed so that the Treasury would have an opportunity to suggest changes. No corrective legislation has been requested

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[280]Int. Rev. Code of 1954, §277(a).

[281]*Anaheim Union Water Co.* v. *Commissioner,* 321 F. 2d 253 (9th Cir. 1963), *reversing* 35 T.C. 1072 (1961).

[282]S. Rep. 91-552, 91st Cong., 1st sess. 74 (1969), Senate Comm. on Finance to Accompany H.R. 13270. Compare the new Code section 277 with section 281 of the Code (added by Pub. L. 87-870, Oct. 23, 1962, 76 Stat. 1158) which permits terminal railroad corporations to do what section 277 seems to deny taxable membership organizations. Section 281 of the Code provides special rules for terminal railroad corporations and their shareholders so that these corporations will not be taxed on related terminal income which is used to reduce the service charges to the shareholder railroads. Section 281 was enacted to overcome the Tax Court decision in *Anaheim Union Water Co.*, 35 T.C. 1072 (1961), subsequently *reversed,* 321 F. 2d 253 (9th Cir. 1963), and the decision in *Chicago and Western Indiana Railroad Co.* v. *Commissioner,* 303 F. 2d 796 (7th Cir. 1962). These cases held that (1) a corporation is to be taxed on its "profits" from business done with nonshareholders even if it uses them to supply services to shareholders at less than cost, and (2) a shareholder is to be

and proposed regulations (Treas. Reg. § 1.277-1) were published in the Federal Register on May 6, 1972.[283]

In the *Anaheim Union Water* case,[284] the taxpayer, a nonexempt nonprofit mutual water company, sold water exclusively to its shareholders. It also received substantial income from rentals and in royalties from oil and gas deposits in its property. The company was thereby able to provide water to its shareholders below cost, the charges for water being the difference between income from all other sources and the expenses incurred by the company. It was allowed to deduct as ordinary and necessary business expenses the cost of furnishing water to the shareholders even though the costs exceeded the amount received from the sale of water. The court based its holding, in part, upon the fact that the company was required to supply its shareholders with water at cost without profit and that its bylaws required it to use all of its "income" to accomplish the furnishing of water and upon the further fact that the cost of the water was its fair market value. The court reasoned:

> Unless the fair market value of the water exceeded the price which the shareholders paid, the shareholders received nothing more than what they paid for and there was no distribution of income or property.

The principle of *Anaheim* was affirmed in 1970 in other cases involving water companies.[285] On the other hand, a contrary result had been reached in 1962 in a terminal rail-

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treated as if he had paid cost for the services and had received the "profits" in the form of a dividend. For an application of section 281, see *Chicago Union Station Co.* v. *United States*, 276 F. Supp. 577 (N. D. Ill. 1967).

[283]37 Fed. Reg. 9278. The proposed regulations have reserved a section (§1.277-3) for "Interrelationship with cooperatives subject to rules contained in subchapter T, chapter 1 of the Code."

[284]321 F.2d 253 (9th Cir. 1963).

[285]See *Bear Valley Mutual Water Co.* v. *Riddell*, 283 F. Supp. 949 (C.D. Calif. 1968), and *San Antonio Water Co.* v. *Riddell*, 285 F. Supp. 297 (C.D. Calif. 1968), both *affirmed* on the basis of *Anaheim*, in 427 F. 2d 713 (9th Cir. 1970), where the court also observed: "It is here noted that the Anaheim problem apparently goes away with legislation to become effective January, 1971. See Public Law 91-172, 83 Stat. 487."

road case,[286] and again as recently as 1972 in *Adirondack League Club*,[287] involving a conservation, hunting, fishing, and recreation association. At issue in *Adirondack* were questions for tax years prior to the effective date of new section 277.

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[286] *Chicago and Western Indiana Railroad Co.* v. *Commissioner,* 303 F. 2d 796 (7th Cir. 1962). See *Chicago Union Station Co.* v. *United States,* 276 F. Supp. 577 (N.D. Ill. 1967), applying section 281 of the Code. See also footnote 282 in this section.

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Zivan, *Need for Reform in Taxation of Agricultural Cooperatives,* 5 Ga. L. Rev. 529 (1971).

Taylor, *Taxation and Sound Cooperative Growth,* American Cooperation, 1972-73, 274.

Fleck, *Nonqualified Written Notices of Allocation May Salvage a Coop's Otherwise Lost Benefits,* 38 J. Taxation 378 (1973).

Note, 34 Va. L. Rev. 314 (1948).

Note, 23 Notre Dame Law 342 (1948).

Note, 32 Minn. L. Rev. 785 (1948).

Note, 27 Ind. L. J. 447 (1952).

Note, 5 S.D. L. Rev. 79 (1960).

Note, 1966 Wis. L. Rev. 930 (1966).

Patronage Refunds

To ensure that a cooperative will achieve its purpose of operating on a service-at-cost basis, it should be obligated to account on a patronage basis to all its patrons for all amounts received from the furnishing of services in excess of operating costs and expenses properly chargeable against the type of service furnished.[1] Such amounts are sometimes referred to

[1]See "Nonprofit Associations," *supra*, p. 219 and "Sample Legal Documents," *infra*, p. 578.

as patronage refunds. Originally they were called patronage dividends, but the trend is to call them refunds. Actually they are not dividends at all in the sense in which the term is ordinarily employed. Rather, they are savings.

The aim of a cooperative, whether marketing or purchasing, is to operate on a cost basis, or as near thereto as practicable. Refunds based on patronage are simply a means of enabling associations to achieve this result more easily.[2]

As a Federal district court has stated:

> *** Since October 24, 1844, *** the so-called Rochdale principles have been recognized. *** While these principles have been variously stated by different authorities, they all agreed upon the inclusion therein of the principle that distribution of the surplus originating in the economic activity of an organization is in direct proportion to the participation of members ***.[3]

Accordingly, the court said:

> The patronage dividends to be paid to producers in a farmers' cooperative need not be and should not be the same to every patron.

Patronage refunds are not a part of the gross income of a cooperative, since the cooperative is obligated to return these amounts to the persons to whom they are paid.[4]

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[2]Adcock, *Patronage Dividends: Income Distribution or Price Adjustments*, 13 Law & Contemp. Prob. 505 (1948); Jensen, *The Collecting and Remitting Transactions Of A Cooperative Marketing Corporation*, 13 Law & Contemp. Prob. 403 (1948); Gardner and Volkin, *What Are Patronage Refunds?*, FCS Information 34, Farmer Cooperative Service, U.S. Dept. Agr. (1972); Davidson, *Methods and Policies Used in Making Patronage Refunds by Selected Farmer Cooperatives*, FCS General Report 137, Farmer Cooperative Service, U.S. Dept. Agr. (1966); Davidson, *How Farm Marketing Cooperatives Return Savings to Patrons*, FCS Res. Rpt. 7, Farmer Cooperative Service, U.S. Dept. Agr. (1970).

[3]*Bowles* v. *Inland Empire Dairy Association*, 53 F. Supp. 210, 216 (E.D. Wash. 1943).

[4]*State* v. *Morgan Gin Company*, 186 Miss. 66, 189 So. 817 (1939). See "Federal Income Taxes," at p. 367. See also *Gallatin Farmers Co.* v. *Shannon*, 109 Mont. 155, 93 P. 2d 953 (1939); *Uniform Printing and Supply Co.* v. *Commissioner*, 88 F. 2d 75 (7th Cir. 1937); *Appeal of Paducah &*

In general, any business, cooperative or otherwise, may pay patronage refunds. Statutes may bar the payment of refunds or rebates by railroads and public utilities, but those engaged in private business may ordinarily make such payments so long as they do not conflict with the contract rights of shareholders.[5]

The proprietor of a commercial cotton gin opposed the granting of a license to a cooperative that desired to engage in the cotton ginning business. He contended that the cooperative was specifically authorized to pay patronage refunds by the statute under which it was incorporated, while he was barred from doing so. The commercial operator argued that he was denied the equal protection of the laws. The Supreme Court of the United States found that inasmuch as no law or regulation of the State had been adduced prohibiting the commercial operator from making patronage refunds, no discrimination was involved.[6]

Patronage refunds depend on the success of the enterprise and are subject to its hazards. They should be distinguished from rebates.[7]

Patronage refunds result from the obligation to return the proceeds of sales, less necessary expenses, to producers. For

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Illinois Railroad Co., 2 B.T.A. 1001 (1925); *United Cooperatives, Inc.*, 4 T.C. 93 (1944); *United Grocers, Ltd.* v. *United States*, 308 F.2d 634 (9th Cir. 1962), *affirming* 186 F. Supp. 724 (N.D. Calif. 1960); *Certified Grocers of Florida, Inc.* v. *United States,* 18 AFTR 2d 5012 (M.D. Fla. 1966); and discussion at notes 8 and 9 under "Nonprofit Associations," *supra.*

[5]*Klein* v. *Greenstein,* 24 N.J. Super. 348, 94 A. 2d 497 (1953), where a State law provision relating to payment of dividends to stockholders did not preclude a plan for patronage refunds. But see *Midland Cooperative Wholesale* v. *Ickes*, 125 F.2d 618 (8th Cir. 1942).

[6]*Corporation Commission of Oklahoma* v. *Lowe*, 281 U.S. 431 (1930). See also *Guthrie Cotton Oil Co.* v. *Farmers' Custom Gin*, 156 Okla. 16, 9 P. 2d 32 (1932); *Southwestern Cotton Oil Co.* v. *Farmers' Union Coop. Gin Co.*, 165 Okla. 31, 24 P.2d 658 (1933); *Chickasha Cotton Oil Co.* v. *Cotton County Gin Co.*, 40 F.2d 846 (10th Cir. 1930), 74 A.L.R. 1070; *Choctaw Cotton Oil Company* v. *Corporation Commission of Oklahoma*, 121 Okla. 51, 247 P. 390 (1926).

[7]Bunn, *Consumers' Cooperatives And Price Fixing Laws,* 40 Mich. L. Rev. 165 (1941); *Certified Grocers of California, Ltd.* v. *State Board of Equalization,* 100 Cal. App. 2d 289, 223 P. 2d 291 (1950); *Eaton* v. *Brock,* 124 Cal. App. 2d 10, 268 P. 2d 58 (1954).

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instance, some marketing cooperatives have a fixed charge per unit for the marketing of the commodity they handle. Generally this is the same as the going rate charged by other operators. Other cooperatives pay the current price or a series of advances as inventories are sold. In each case, it is contemplated that at the end of the year, or of a fixed period, the operating costs and expenses of the association will be ascertained and the amount remaining will be distributed among the members on the basis of the quantity or value of the products marketed by the association for each of them.

When marketing associations use a schedule of charges, it is expected that returns from marketing will more than cover all operating expenses, but obviously the exact amount of the expenses cannot be known in advance. Likewise, in the case of associations that pay a series of advances or the current price for products handled, it is contemplated that the products will be sold for prices that will leave a balance after meeting all expenses. But, here again, the amount of this balance is unknown in advance. At the end of the year, or of a fixed period, the expenses of the association are ascertained; and this amount is subtracted from the total amount received by the association for handling charges or from the total sale price of the products. The balance is then returned to the patrons of the association on the basis of the volume, or of the value, of the products each marketed through the association.[8]

Patronage refunds are a means of returning to patrons savings effected by their cooperatives in marketing their products or purchasing their supplies. Manifestly, this is fundamental to cooperation, because there would be less incentive to cooperate if the savings effected in marketing expenses, or elsewhere, could not be returned to patrons. Patronage refunds are based upon products delivered and sold or upon purchases made and not upon money invested.

Some associations ascertain the amount of the patronage refund to which a patron is entitled in substantially the following manner: First, the total amount available for distribution among the patrons at the end of the year or other period is determined. Then, this amount is divided by the volume of business handled by the association in terms, for instance,

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[8]Sometimes the distribution is only among patrons who are members. In such cases, only that part of the distribution which represents the margins on the member business is a true patronage refund. See *Iberia Sugar Cooperative, Inc.* v. *United States,* 480 F. 2d 548 (5th Cir. 1973).

of cars, bushels, pounds, head, or the value of the product handled in dollars, or the amount paid to the association as handling charges. The figure thus found, when multiplied, for example, by the number of bushels handled for a given member, gives the amount of his patronage refund.[9]

Other associations ascertain their patronage refunds by dividing the total amount available for distribution by the total sale price of the products handled and then multiplying the resulting percentage by the price received for the products of each patron.

Patronage refunds would not be necessary if, at the time the members delivered their products to their association, or at the time of their sale, the association knew the exact amount it would cost to market the products of its members.

Patronage refunds simply furnish a medium by which the undertaking of the association to operate on a cost basis, or as near thereto as possible, may be carried out.

A novel patronage refund case involved a plaintiff who was not only a farmer and a stockholder in the defendant cooperative but who also engaged in the grain business.[10] The court concluded that the plaintiff was not entitled to patronage refunds on grain he had purchased from the cooperative, but that the other shareholder patrons were entitled to the amount involved. The Kansas statute under which the elevator cooperative was incorporated, provided that, after the payment of a fixed dividend upon stock, the remaining "earnings" should be prorated to its several stockholders upon the basis of their purchases or sales, or on both. The court took the view that the purchase by the plaintiff of grain from the elevator on a commercial basis was not such a purchase as was contemplated by the statute and, hence, that he was not entitled to patronage refunds.

The Grain Futures Act of September 21, 1922,[11] provides that the Secretary of Agriculture may designate any board of trade as a "contract market," if among other things—

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[9] *Mooney* v. *Farmers' Mercantile & Elevator Co.*, 138 Minn. 199, 164 N.W. 804 (1917).

[10] *McClure* v. *Co-operative Elevator & Supply Co.*, 105 Kan. 91, 181 P.573 (1919). See Rev. Rul. 66-380 as distinguished in Rev. Rul. 72-547 and commented on in T.I.R. 1208, Oct. 20, 1972, all discussed at p. 433 under "Federal Income Taxes."

[11] 42 Stat. 998, 1000, 1001.

> the governing board thereof does not exclude from membership in, and all privileges on, such board of trade, any duly authorized representative of any lawfully formed and conducted cooperative association of producers having adequate financial responsibility which is engaged in cash grain business, if such association has complied, and agrees to comply, with such terms and conditions as are or may be imposed lawfully on other members of such board: *Provided,* That no rule of a contract market shall forbid or be construed to forbid the return on a patronage basis by such cooperative association to its bona fide members of moneys collected in excess of the expense of conducting the business of such association.

The Supreme Court of the United States, in upholding the constitutionality of the Grain Futures Act,[12] referred particularly to the paragraph of the statute quoted in part above and said:

> Nor do we see why the requirement that the relation between them and this representative, looking to economy of participation on their part by a return of patronage dividends, should not be permissible because facilitating closer participation by the great body of producers in transactions of the Board which are of vital importance to them. It would seem to make for more careful supervision of those transactions in the national public interest in the free flow of interstate commerce.

A Kansas statute[13] required boards of trade in the State which were not operating under the Federal Grain Futures Act to admit cooperatives. This act specified that the making of refunds by a cooperative should not be a cause for exclusion. This statute was upheld by the Supreme Court of Kansas, which, in its opinion, said:

> The sole objection is that plaintiff sees fit to distribute its profits in a manner objectionable to defendant. One is tempted to inquire: What concern is it of defendant what plaintiff does with its profits, whether

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[12] *Board of Trade of the City of Chicago* v. *Olsen,* 262 U.S. 1 (1923).

[13] Laws of Kansas 1925, ch. 6.

it retains them for additional working capital, or disburses them to its stockholders? And if it does disburse them to its stockholders, why should defendant be concerned with the basis of such disbursement, so long as it is satisfactory to plaintiff and its stockholders, and in conformity with the statute under which it was created? It may be doubted whether plaintiff's method of disbursing profits is correctly construed as a violation of defendant's bylaws against rebating or refunding commissions.[14]

The Packers and Stockyards Act, 1921 recognizes the right of cooperative livestock market agencies to pay patronage refunds to their producer members.[15] This statute was upheld by the Supreme Court of the United States.[16] The Robinson-Patman Act permits associations of producers or consumers to pay patronage refunds.[17] In addition, there are certain other Federal statutes which recognize the right of cooperatives to pay patronage refunds.[18]

Where a marketing contract obligated a grower to deliver a certain percentage of his products to an association and the bylaws provided that patronage refunds were payable only to growers who fulfilled their marketing contracts, a grower who failed to deliver the required percentage of his crop was not entitled to receive a patronage refund.[19]

A nonmember patron of an association cannot compel it to pay him patronage refunds where its organization papers and procedure do not provide for doing so.[20]

Nonmember tenants and sharecroppers of a landlord member of a cooperative gin have been held entitled to a share of

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[14]*Farmers' Co-op Commission Co.* v. *Wichita Board of Trade,* 121 Kan. 348, 246 P.511, 513 (1926), 54 A.L.R. 295, *writ of error dismissed,* 275 U.S. 574 (1927).

[15]42 Stat. 159, 7 U.S.C. 181. See Rev. Rul. 73-59, 1973-1 Cum. Bull. 292.

[16]*Stafford* v. *Wallace,* 258 U.S. 495, 23 A.L.R. 229 (1922).

[17]*Quality Bakers of America* v. *Federal Trade Commission,* 114 F. 2d 393 (1st Cir. 1940).

[18]See "Federal Statutes Mentioning Cooperatives," p. 521.

[19]*Rusconi* v. *California Fruit Exchange,* 101 Cal. App. 750, 281 P. 84 (1929).

[20]*Farmers Truck Association* v. *Strawberry & Vegetable Auction, Inc.,* 163 So. 181 (La. App. 1935).

the patronage refunds paid by the gin to the landlord.[21] Although suit was against the landlord, the court laid great stress on the fact that the organization papers of the gin required it to treat all patrons, members and nonmembers, alike in the distribution of patronage refunds. The court said:

> The making of such payments results in a refixing and reduction of the original charge for ginning and a corresponding increase in the net proceeds derived from the sale of the cotton. The fact that the legal title to the cotton was in appellant does not lessen his obligation to pay over to appellees one-half of such net proceeds under the terms of their contract. In the absence of a stipulation in the contract to the contrary, appellees were, therefore, entitled to share equally with appellant in the patronage payments ***.[22]

As pointed out in the discussion regarding Federal income taxes,[23] an association cannot qualify under Section 521 of the Internal Revenue Code of 1954 unless it deals with nonmembers on the same basis as that on which it deals with members. If such an association pays patronage refunds to its members, it must likewise pay such refunds to its nonmember patrons.

A fact frequently overlooked is that virtually all persons who carry life or other insurance in a mutual company receive the equivalent of patronage refunds.[24] The amounts received are not normally referred to as patronage refunds, but in essence they are practically the same thing.

The undertaking of a mutual insurance company has been said to contemplate the furnishing of insurance on a basis that will enable it to meet all of its obligations, including current and prospective expenses incident to maintaining and operating the company. At the end of a year or other period, mutual insurance companies ascertain the amount of the items referred to (due consideration being given to the risks and hazards involved) and then return to the patrons or

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[21] *Houck* v. *Birmingham*, 217 Ark. 449, 230 S.W. 2d 952 (1950); *Collie* v. *Coleman*, 223 Ark. 206, 265 S.W. 2d 515 (1954).

[22] *Houck* v. *Birmingham*, *supra*, at 955 (1950).

[23] See "Federal Income Taxes," p. 415.

[24] *Williams* v. *Union Central Life Insurance Co.*, 291 U.S. 170, 92 A.L.R. 693 (1934).

policyholders sums of money called dividends in cash or by credit against premiums which are based upon the amounts paid by the policyholders and found unnecessary for the purposes specified.

An insurance company cannot determine in advance the precise amount that should be charged for insurance to cover the items in question, nor can a cooperative determine in advance the precise amount necessary to meet its expenses. Insurance companies charge enough for insurance to cover all possible contingencies, with the idea of returning any surplus to policyholders at the end of a given period. Cooperatives follow a like practice.

It has been said that--

> So-called dividends upon life insurance policies are not really "dividends," but are the return by a mutual company of the unearned portion of the premium for the past year, unearned because of saving in expected mortality, saving in expense loading, and increase in investment earnings over the expected 3½ percent. To the extent of the combined savings due to these three elements, theoretically at least, the premiums paid in advance are regarded as having been excessive or unearned.[25]

Patronage refunds represent a practical means of achieving a given result, namely, the return to the patrons of an association of savings effected by it.

Patronage refunds are sometimes called "underpayments" in marketing cooperatives or "overpayments" to farm supply cooperatives, after operating costs and expenses have been deducted. Thus, unless there is a net margin, there is no patronage refund. The Internal Revenue Code[26] also places limits on what may be included in "deductible" patronage refunds for tax purposes. Specifically, a "patron-

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[25] *Atlantic Life Insurance Company* v. *Pharr,* 59 F.2d 1024, 1026 (6th Cir. 1932).

[26] 26 U.S.C. 1388(a). See also "Federal Income Taxes," p. 426, and *Des Moines County Farm Service Co.* v. *United States,* 324 F. Supp. 1216 (S.D. Iowa 1971), *affirmed,* 448 F. 2d 776 (8th Cir. 1971); *Iberia Sugar Cooperative, Inc.* v. *United States,* 480 F. 2d 548 (5th Cir. 1973).

age dividend" as defined in the Internal Revenue Code of 1954 does not include any amount paid to a patron to the extent that the amount is out of "earnings" other than from business done with or for patrons, or is out of "earnings" from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

Directors act at their peril in authorizing the payment of refunds of any character unless the facts justify doing so.[27]

At common law, the declaration of a dividend is a matter for action by the board of directors and not by the stockholders, and this rule also applies to an authorization to pay cash patronage refunds.[28] But bylaws could provide for referring this matter to the members.[29]

In the absence of specific agreement or conditions to the contrary, a patronage refund does not constitute a liability of an association until declared.[30] Following the declaration, it represents a debt of the corporation.[31]

Revolving-Fund Plan of Financing

Money furnished by patrons for capital purposes should be regarded by them as an investment in their own associa-

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[27] *Fawkes* v. *Farm Lands Investment Company,* 112 Cal. App. 374, 297 P. 47 (1931); *Ellis* v. *French-Canadian Cooperative Association,* 189 Mass. 566, 76 N.E. 207 (1905); *Towles* v. *South Carolina Produce Association,* 187 S.C. 290, 197 S.E. 305 (1938); *Doss* v. *Farmers Union Co-op Gin Co.,* 173 Okla. 70, 46 P.2d 950 (1935). The respective rights of preferred shareholders and patrons must be considered and a board's failure to make adequate provision for dividends on preferred stock was the basis for suit against the directors in *Collie* v. *Little River Cooperative, Inc.,* 370 S.W.2d 62 (Ark. 1963).

[28] *Callaway* v. *Farmers' Union Co-op Ass'n of Fairbury,* 119 Neb. 1, 226 N.W. 802 (1929).

[29] *Callaway* v. *Farmers' Union Co-op Ass'n of Fairbury,* 119 Neb. 1, 226 N.W. 802 (1929).

[30] *Fruit Growers' Supply Company* v. *Commissioner,* 56 F.2d 90 (9th Cir. 1932), *affirming* 21 B.T.A. 315 (1930).

[31] 11 Fletcher Cyc. Corp. (Perm. Ed.), § 5365.

tion and not as an additional expense.[1] It takes money to go into business. Farmers, when they form and operate a cooperative, are in business and should supply an appropriate amount of the required capital.

Some cooperatives use a revolving-fund plan of financing to resolve the problem of how equitably to capitalize a cooperative so that the capital furnished by a particular member will bear a direct relation to his patronage and ultimately will be returned to him.[2]

Many cooperatives began business with a small amount of capital. Over the years, the amount increased through an accumulation of capital savings without giving patrons a clearly defined right with respect to the sums that each by reason of his patronage had provided. Frequently, the early patrons of an association were largely responsible for building up its capital, while later patrons were not expected to make comparable investments. A revolving-fund plan of financing can avoid such inequalities.

Broadly speaking, the plan is one under which, after sufficient capital has been accumulated to justify doing so, money supplied for capital purposes by current patrons is used to retire the oldest outstanding capital investments of patrons in the revolving fund.

In farm supply cooperatives under the revolving-fund plan, most capital originates from savings the patrons authorize the association to keep for them, or from the sale of certificates of various kinds. Thus, with patrons' consent, these cooperatives pay a portion of each year's savings in

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[1]See *United States* v. *Mississippi Chemical Corp.,* 405 U.S. 298 (1972), holding that the cost of certain class "C" stock in a bank for cooperatives was not a deductible expense but the acquisition of a capital asset. Lower courts have split on the issue presented in this case. Compare, *e.g., M.F.A. Central Cooperative* v. *Bookwater,* 427 F.2d 1341 (8th Cir. 1970), *reversing* 286 F. Supp. 956 (E.D. Mo. 1968), *certiorari denied,* 405 U.S. 1045 (1972), with *Penn Yan Agency Cooperative, Inc.* v. *United States,* 417 F.2d 1372 (Ct. Cl. 1969).

[2]Sanders, *"Retains" That Nobody Feels,* 3 News for Farmer Cooperatives 5-6, Farmer Cooperative Service, U.S. Dept. Agr. (1936); Sanders, *Organizing A Farmer's Cooperative,* FCS Circ.18, Farmer Cooperative Service, U. S. Dept. Agr. (1956); Nieman, *Revolving Capital in Stock Cooperative Corporations,* 13 Law & Contemp. Prob. 393 (1948). See also Hulbert, Griffin, and Gardner, *Revolving Fund Method of Financing Farmer Cooperatives,* FCS General Report 41, Farmer Cooperative Service, U.S. Dept. Agr. (1958).

cash (at least 20 percent to qualify the refunds as "qualified written notices of allocation" under the tax laws),[3] and the remainder by an offset against the obligation of each patron to invest in the capital of the association.[4] The resulting patrons' investment in capital may be evidenced by stock, capital book credits, or some form of certificate of ownership.

In marketing cooperatives under the revolving-fund plan, money for capital purposes is furnished in a manner similar to that used by farm supply cooperatives, and also through authorized "capital retains" made on a percentage or unit basis.[5]

The meaning of the term "revolving-fund plan" becomes more apparent when a cooperative reaches the stage when the oldest capital investments of patrons of previous years may be returned to them.

There is wide latitude with respect to the terms and conditions that may be adopted for a revolving-fund plan of financing.[6] Under this plan of financing, amounts furnished for capital purposes should be recorded on the books of the association so that the ownership interest of those who provided the capital will be known. Some associations set up book credits and, although not essential, also issue to pa-

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[3]See "Federal Income Taxes," *supra,* at p. 426. Some cooperatives pay more than 20% in cash. Griffin, *A Financial Profile of Farmer Cooperatives in the United States,* Res. Rpt. 23, Farmer Cooperative Service, U.S. Dept. Agr. (1972).

[4]The practice of setting off the cooperative's obligation against the patron's obligation is frequently referred to as paying the net margins in stock or some other noncash form. The use of this shorthand way of speaking has tended to obscure the actual character of the transactions and the legal theory underlying them. It undoubtedly has contributed to some unsound analysis and thinking on the part of many people, especially those unfamiliar with the cooperative method of doing business. See Nieman, *Multiple Contractual Aspects of Cooperatives' Bylaws,* 39 Minn. L. Rev. 135, 143 (1955).

[5]See "Capital Retains," *supra,* at p. 443.

[6]Hulbert, Griffin, and Gardner, *Revolving Fund Method of Financing Farmer Cooperatives,* FCS General Report 41, Farmer Cooperative Service, U.S. Dept. Agr. (1958); Griffin, *How Adjustable Revolving Fund Capital Plan Works,* FCS General Report 111, Farmer Cooperative Service, U.S. Dept. Agr. (1963). For bylaw provisions, see "Sample Legal Documents," *infra,* p. 567.

trons some type of certificate to evidence their ownership interest.[7] These credits or certificates have been called "capital credits," "revolving-fund certificates," "certificates of equity," or "certificates of ownership." Regardless of the designation used, the rights of both the cooperative and the patrons would depend upon the terms and conditions under which the capital was supplied.

Some associations organized with capital stock issue stock certificates to evidence patrons' investments increasing the capital revolving fund. From a legal standpoint, there appears to be no reason why either stock or nonstock associations may not issue certificates other than certificates of stock. If an association revolves its capital stock, at least one share of voting stock should be held at all times by producers who are to continue as members of the association.[8] If a capital stock association plans to revolve its stock, it should either: (1) issue more than one class of common stock, keeping one class as voting stock and revolve the other class, or (2) issue both common and preferred stock and revolve the preferred, keeping the common—usually issued on the basis of one share to each producer—as the voting stock.

The organization papers of a cooperative should clearly show how its revolving-fund plan of financing is intended to function. Nothing should be left to surmise or inference. If no interest is to be paid on capital funds, the papers should so state. Likewise, if it is intended that interest be paid on capital funds, definite provision should be made for it. In some instances, the payment of interest is made optional with the board of directors and is not to exceed a stated percent per annum.

Usually, the certificates issued do not have due dates and are subject to retirement only at the discretion of the board of directors. If such certificates do have due dates, the capital status of funds they represent is changed. In the true sense, these funds would no longer be considered equity cap-

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[7]See text at footnote 16, in this section. See also the requirements for "qualified" and "nonqualified" written notices of allocation under the tax laws discussed under "Federal Income Taxes," *supra,* at p. 430.

[8]See *Co-operative Grain & Supply Co.* v. *Commissioner,* 407 F.2d 1158 (8th Cir. 1969), and Rev. Proc. 73-39, 1973-2 Cum. Bull. 502.

ital because they have taken on the basic characteristic of debt capital.

Some associations maintain contingency reserves with the thought that this will "insure" that certificates issued or credits given for funds obtained for capital purposes will remain at par. Such reserves are expected to operate as a cushion to absorb losses. If reserves are set aside for meeting contingencies, they should be allocated to the patrons on the books of the association and revolved when circumstances warrant.[9] In case of losses, the allocated interest of patrons in such reserves might be reduced on some equitable basis. The bylaws of some associations give the board of directors authority to make such a reduction.

As previously indicated, a sharp line of demarcation should be drawn between operating expense items and capital investments made by members and patrons of an association.[10]

In recent years, a number of cooperatives, including several large fruit and vegetable marketing cooperatives, have modified or adjusted their revolving-fund plans in an effort to provide for a more equitable and more permanent capital structure.[11]

When a cooperative has been in business for a number of years, a portion of its membership may become inactive for various reasons and deliveries of products to the cooperative, or purchases from it, become irregular. As a result, some financial inequities among members arise in the administration of revolving-fund financing plans.

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[9]See "Federal Income Taxes," *supra,* at p. 407.

[10]See "Nonprofit Associations," *supra,* at p. 219.

[11]Griffin, *How Adjustable Revolving Fund Capital Plan Works,* FCS General Report 111, Farmer Cooperative Service, U.S. Dept. Agr. (1963); Griffin and Wissman, *Financial Structure of Farmer Cooperatives,* FCS Res. Rpt. 10, Farmer Cooperative Service, U.S. Dept. Agr. (1970); Mather, *Sun-Maid Moves to Adjustable Capital Plan,* Reprint 370, News for Farmer Cooperatives (May 1970); and Griffin, *Modern Cooperative Financing,* a talk given at a seminar on cooperatives at Chippewa Lake Field Station, Clam Lake, Wis., August 10, 1970. See Rev. Rul. 70-298, 1970-1 Cum. Bull. 82, holding that the exchange of revolving-fund credits for share interests in a permanent capital fund by a section 521 farmer cooperative constitutes a recapitalization and therefore a reorganization within the meaning of section 368(a)(1)(E) of the Internal Revenue Code of 1954.

The modified plan is generally referred to as a permanent or base capital plan of financing. Basically, it provides for a temporary freezing of existing revolving funds, an independent determination of total capital requirements, and an annual determination of individual capital requirements, generally based upon relative patronage over a specified number of years. There is no separate retention or revolvement of funds, but essentially *net retain or revolvement,* depending upon the extent to which a member's existing capital measures up to the requirement allocated to him.[12]

The validity of the revolving-fund plan of financing has been specifically recognized.[13] A member of a cooperative, like a member of any other business corporation may, of course, provide capital for his corporation or he may be an ordinary creditor. He may make an outright loan to a cooperative and thus become a creditor in the sense in which that term is customarily used. Likewise, a member who supplies money to an association for capital or other purposes may make it available subject to specific terms and conditions. In the absence of fraud, the courts will ordinarily enforce the terms of such agreements.

A cooperative of retail grocers operated a wholesale agency. Under its bylaws, 1 percent was added to all statements for the purpose of creating a credit reserve fund "to guarantee the accounts of all members with the Association who receive credit." The bylaws also provided that the amount credited to each member's reserve account "shall be returnable with interest upon the member ceasing to be a member of the Association," less a pro rata percentage

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[12]For a detailed explanation of how this plan works, see Mather, *Sun-Maid Moves to Adjustable Capital Plan,* Reprint 370, News for Farmer Cooperatives (May 1970). See also Rev. Rul. 70-298, 1970-1 Cum. Bull. 82, which describes an exchange of revolving fund credits for share interests in a permanent capital fund. See footnote 11 in this section.

[13]*Reinert* v. *California Almond Growers Exchange,* 9 Cal. 2d 181, 63 P.2d 1114 (1936), 70 P.2d 190 (1937); *Adams* v. *Sanford Growers' Credit Corporation,* 135 Fla. 513, 186 So. 239 (1938); *Ozona Citrus Growers' Association* v. *McLean,* 122 Fla. 188, 165 So. 625 (1935); *Proodian* v. *Plymouth Citrus Growers Association,* 143 Fla. 788, 197 So. 540 (1940); *Parker* v. *Dairymen's League Cooperative Association, Inc.,* 222 App. Div. 341, 226 N.Y.S. 226 (1927); *Loomis Fruit Growers' Association* v. *California Fruit Exchange,* 128 Cal. App. 265, 16 P. 2d 1040 (1932). See *Farmers Union Co-op Gin Co.* v. *Taylor,* 197 Okla. 495, 172 P.2d 775

of losses sustained by the Association on account of credit extended to members. The funds thus accumulated were not held out as constituting part of the assets of the cooperative. The wholesale agency was placed in bankruptcy and its creditors contended that the members had no claims against the bankrupt on account of their contributions to the credit reserve fund. The court held otherwise.[14] In contrast, cooperatives using the revolving-fund plan of financing usually provide that the obligations of the association to the holders of revolving-fund certificates are junior and subordinate to the claims of other creditors. Thus, the opinion in this case seems to go much further than a court would ordinarily be called upon to go. The status of revolving-fund certificates which are junior and subordinate to other claims is similar to that of ordinary stock certificates.

Authority for the revolving-fund plan of financing is found in the general rule that a corporation may purchase stock it has issued. The general rule appears to be that:

> A private corporation may purchase its own stock if the transaction is fair and in good faith; if it is free from fraud, actual or constructive; if the corporation is not insolvent, or in process of dissolution; and if the rights of its creditors are in no way affected thereby.[15]

Since, under the conditions stated in this quotation, a corporation may purchase its capital stock, it seems clear that a cooperative may revolve the capital it has in its revolving fund. In the usual situation a cooperative would not be depleting its capital because the capital currently being supplied would normally be equivalent to the amount retired. The cooperative would thus be left with substantially the same amount of capital after the transaction. In any event, there would appear to be no basis for applying a stricter rule to the retirement of funds in a revolving fund

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(1946). See Rev. Rul. 70-298, cited at footnotes 11 and 12, in this section.

[14] *Warner* v. *Schoner,* 90 F.2d 579 (9th Cir. 1937).

[15] *Porter* v. *Plymouth Gold Mining Company,* 29 Mont. 347, 74 P.938, 101 Am. St. Rep. 569 (1904). See also *Griffin* v. *Bankers' Realty Investment Company,* 105 Neb. 419, 181 N.W. 169 (1920); *Howe Grain & Mercantile Company* v. *Jones,* 21 Tex. Civ. App. 198, 51 S.W. 24 (1899); *Atlanta*

than is applied in a case involving the ordinary purchase by a corporation of its own stock.

As previously indicated, an association may use stock, revolving-fund certificates, certificates bearing a different designation, or capital credit notices to evidence capital in the revolving fund. But, again, it is not necessary that any form of certificate be issued to evidence such capital if the bylaws are clear and specific as to the rights and obligations of both the cooperative and its patrons.[16]

Where it is clear that the obligation of an association to its members for money furnished by them for a revolving fund is junior and subordinate to the rights of creditors, the right of the association to retire any part of the revolving fund would be subject to the rights of existing creditors. The law is well established that a corporation may not retire any part of its capital stock if doing so would adversely affect the rights of current creditors.

In a Minnesota case involving a cooperative, it was said:

> To the extent that money, goods or stockholder's notes were exchanged for the stock, the capital of the corporation was depleted. The capital was its own property, but it could not be withdrawn or distributed among stockholders without provision being first made for the full payment of corporate debts.[17]

The revolving-fund plan of financing would seem permissible under the laws of any State, since it constitutes a valid contractual relationship for which there need be no specific statutory authority. Some States have specifically authorized such a plan.[18]

Although a member may have withdrawn from an asso-

& Walworth Butter & Cheese Association v. *Smith,* 141 Wis. 377, 123 N.W. 106, 32 L.R.A. (N.S.) 137, 135 Am. St. Rep. 42 (1909); *Koeppler* v. *Crocker Chair Company,* 200 Wis. 476, 228 N.W. 130 (1929).

[16]See *Appeal of Paducah & Illinois Railroad Co.,* 2 B.T.A. 1001 (1925), discussed under "Taxation of Nonexempt Cooperatives," *supra,* p. 364.

[17]*Lebens, As Receiver of the LeSueur County Cooperative Creamery* v. *Nelson,* 148 Minn. 240, 181 N.W. 350, 352 (1921). See also *Learmouth* v. *Caledonia County Cooperative Association,* 109 Vt. 526, 1 A.2d 732 (1938).

[18]Iowa Code Ann. §499.30, 499.33; Utah Code Ann. §3-1-9.

ciation, this does not give him a right to receive his interest in a revolving fund, except at the time and in the manner provided in the statute, the bylaws, or other agreement with the association.[19]

Whether State blue sky laws apply to revolving-fund or other like certificates is a question which should be determined. A corporation was prohibited from offering for sale certain so-called goodwill contracts unless and until a permit had been issued by the Railroad Commission of Wisconsin. The court, in reviewing the matter, pointed out that the goodwill contracts were neither stock nor bonds, but held that this did not prevent them from being a security within the definition of the statute.[20]

Associations Operating in Various States

May an association formed under the laws of one State do business in other States? The power of a corporation to act outside the State of its creation generally need not be expressly conferred, but may be implied; provided, of course, the State in which a foreign corporation does business consents and there is no charter restriction.

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[19] *Reinert* v. *California Almond Growers Exchange,* 9 Cal. 2d 181, 63 P. 2d 1114 (1936), 70 P. 2d 190 (1937); *Parker* v. *Dairymen's League Cooperative Association, Inc.,* 222 App. Div. 341, 226 N.Y.S. 226 (1927). In *Clarke County Cooperative* v. *Read,* 243 Miss. 879, 139 So. 2d 632 (1962), a patron's equity credits issued under a revolving-fund plan could not be used as a setoff in a suit against the patron on his note. *Cf. In the Matter of Great Plains Royalty Corporation, et al.,* 471 F. 2d 1261 (8th Cir. 1973), involving a bankrupt corporation, discussed in footnote 260, "Electric and Telephone Cooperatives," *supra.* See *Lambert* v. *Fisherman's Dock Cooperative, Inc.,* 115 N.J. Super. 424, 280 A. 2d 193 (1971), *modified and remanded,* 61 N.J. 596, 297 A.2d 566 (1972); *Evanenko* v. *Farmers Union Elevator,* 191 N.W. 2d 258 (N.Dak. 1971); *Claassen* v. *Farmers Grain Cooperative,* 208 Kan. 129, 490 P.2d 376 (1971); and "Termination of Membership," *supra,* at p. 99 and "Interest in Association," *supra,* at p. 102. *Cf. Weise* v. *Land O'Lakes Creameries, Inc.,* 191 N.W.2d 619 (Iowa 1971), where the court found that the acquisition of the assets of a turkey producers' association by another cooperative was not a merger but a sale and dissolution entitling dissatisfied members of the turkey association to payment of their revolving fund credits on dissolution of their association.

[20] *Brownie Oil Company* v. *Railroad Commission,* 207 Wis. 88, 240 N.W. 827, 87 A.L.R. 33 (1932). See also *State* v. *Gopher Tire & Rubber Co.,* 146 Minn. 52, 177 N.W. 937, 938 (1920).

The charter of a corporation is the same abroad as it is at home. Wherever a corporation goes for business it carries its charter as the law of its existence. When a State permits a foreign corporation to come within its borders, it is presumed to have consented that the corporation may exercise all the power conferred by its charter and the applicable laws.[1]

If an association desires to enter into marketing contracts with producers in States other than that in which organized, must the association comply with the laws of those States respecting foreign corporations? All States appear to have statutes relative to foreign corporations doing business within their borders. If a cooperative formed in one State enters into marketing contracts with producers in another State, and the products covered by the contracts on delivery to the association are to be moved out of the State or delivered to the association outside the State in which grown, then it seems clear that an association would not be required to comply with the laws of the State with respect to foreign corporations.[2]

The situation would involve interstate commerce, and a corporation of one State may purchase goods in another State for shipment out of the State without the consent of the latter. The following quotation is taken from an opinion of the Supreme Court of the United States.[3]

> ***In no case has the court made any distinction between buying and selling or between buying for transportation to another State and transporting for sale in another State. Quite to the contrary, the import of the decisions has been that if the transportation was incidental to buying or selling it was not material whether it came first or last.
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> A corporation of one State may go into another, without obtaining the leave or license of the latter, for all

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[1] *Milton-Freewater & Hudson Bay Irrigation Co.* v. *Skeen,* 118 Ore. 487, 247 P. 756, 761 (1926).

[2] *Currin* v. *Wallace,* 306 U.S. 1 (1939). But see *Gwin, White & Prince, Inc.* v. *Henneford,* 193 Wash. 451, 75 P.2d 1017 (1938).

[3] *Dahnke-Walker Milling Co.* v. *Bondurant*, 257 U.S. 282, 291 (1921). See also *Currin* v. *Wallace*, 306 U.S. 1 (1939); 36 Am. Jur.2d, *Foreign Corporations*, §§246, 247.

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the legitimate purposes of such commerce, and any statute of the latter State which obstructs or lays a burden on the exercise of this privilege is void under the commerce clause ***.

In a Nebraska case,[4] it was urged that a cooperative incorporated under the laws of Kansas could not maintain a suit in Nebraska because the association had not complied with the laws of that State respecting foreign corporations, but the Supreme Court of Nebraska held that the association was engaged in interstate commerce and hence was not required to comply with the laws of Nebraska affecting foreign corporations.

The Dark Tobacco Growers' Cooperative Association, incorporated in Kentucky, applied for and received a license to do business in Indiana. It successfully brought suit on a contract it had entered into with a producer in Indiana.[5] One of the defenses interposed was that an association similar to the Dark Tobacco Growers' Cooperative Association could not have been organized in Indiana and hence the license to do business in the State issued to the association was void. The Indiana statute authorized the granting of licenses to do business in the State to associations of a type that could have been formed in Indiana.

The association claimed that it was engaged in interstate commerce, but the court pointed out that the application for a license appeared to be an admission that the association was not engaged in such commerce. The court also noted that the association's complaint had not alleged that the contract sued on was a part of an interstate commerce transaction. The court, however, stated: "If the contract entered into had been a part of a transaction connected with interstate commerce, such license would not have been necessary."

The general statutes of each State regarding the right of a corporation formed in another State to do business

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[4] *Nebraska Wheat Growers' Association* v. *Norquest,* 113 Neb. 731, 204 N.W. 798 (1925).

[5] *Dark Tobacco Growers' Co-op Association* v. *Robertson,* 84 Ind. App. 51, 150 N.E. 106, 110 (1926).

within its borders[6] are as applicable to incorporated cooperatives as to other corporations, unless the language of the particular statute is not broad enough to cover them, the associations are engaged in interstate commerce, or for some other reason such statutes are not by their terms applicable to them.

Generally, an application to do business in a State (other than the one of incorporation) must be made to the secretary of state of that State. Usually before permission to do business in the new State can be obtained, it must appear that a corporation could be formed in that State to engage in the business in which the applicant is engaged. Other requirements include a known place of business and a designated person upon whom process may be served.

A State has the right to exclude the corporations of other States[7] except that a State may not exclude or impose conditions on a corporation that is engaged in interstate or foreign commerce.[8] Again, a corporation of one State may purchase goods in one State for shipment to another without the consent of the latter State. A single isolated act or transaction does not constitute doing business in a State.[9]

Entirely independent, apparently, of the fact that interstate commerce was involved, a number of State supreme courts have held that a foreign corporation was not doing business in the State when it appeared that the foreign corporation consigned products to a commission merchant or factor in the State to be sold.[10] These cases apparently were decided upon the theory that it was the factor or commission man who was engaged in business in that State and not the foreign corporation. It would seem that a cooperative formed in one State, and marketing its products in another, would

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[6]As to the question whether a corporation is "doing business" in a State see 36 Am. Jur. 2d, *Foreign Corporations*, §§316, 317 *et seq.*

[7]*Pembina Consolidated Silver Mining & Milling Co.* v. *Pennsylvania,* 125 U.S. 181 (1888).

[8]*Dahnke-Walker Milling Co.* v. *Bondurant,* 257 U.S. 282 (1921).

[9]*Cooper Manufacturing Co.* v. *Ferguson,* 113 U.S. 727 (1885). See 36 Am. Jur. 2d, *Foreign Corporations,* §§316, 317 *et seq.*

[10]*Allen* v. *Tyson-Jones Buggy Co.,* 91 Tex. 22, 40 S.W. 393 (1897); *In re Hovey's Estate,* 9 Pa. Dist. Rep. 183, *affirmed in* 198 Pa. 385, 48 A. 311 (1901); *Cooper Rubber Co.* v. *Johnson,* 133 Tenn. 562, 182 S.W. 593 (1916); *Bertha Zinc & Mineral Co.* v. *Clute,* 7 Misc. Rep. 123, 27 N.Y.S.

not be required to comply with the laws of the latter State respecting foreign corporations if it sells its products through a commission man, factor, or broker, or through the medium of its own exclusive agent located in that State.

A distinction should be drawn between the right of a State to tax physical property within its borders as contrasted with the right of an individual or corporation to engage in interstate commerce within the State.[11] Physical property, such as commodities,[12] trucks, buildings, or equipment, owned by a cooperative in a State other than that in which it is organized, or similar property owned by the agent of the association in that State, is usually subject to the normal and customary property taxes free from discrimination within that State.[13]

If a cooperative is doing an intrastate business in a State other than that in which it is organized, it is a serious matter for it to fail to comply with the laws of that State regarding foreign corporations. In many States, an association could not sue in the courts of the State, nor could it enforce its obligations in the Federal courts if it had failed to comply with such laws.[14] In Tennessee, the shareholders of a foreign corporation, under the circumstances in question, were held liable as partners.[15] In Colorado and some other States the officers and agents of such a corporation were, by statute, made personally liable.[16]

When a cooperative formed in one State is operating in another, the existence and extent of the right of its members to control the actions of its officers or agents and the relation of the members to the association are determined

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342 (1894); *Badische Lederwerke* v. *Capitelli,* 92 Misc. Rep. 260, 155 N.Y.S. 651 (1915). See also *Patent Royalties Corporation* v. *Land O'Lakes Creameries, Inc.,* 11 F.Supp. 103 (E.D.N.Y. 1935); *Universal Oil Corporation* v. *Falls Rubber Co.,* 188 Okla. 401, 110 P.2d 296 (1941).

[11] 15 Am. Jur. 2d. *Commerce,* §25 *et seq.*

[12] *Sonneborn Bros.* v. *Cureton,* 262 U.S. 506 (1923).

[13] *Southern Ry. Co.* v. *Kentucky,* 274 U.S. 76 (1927).

[14] *Woods* v. *Interstate Realty Co.,* 337 U.S. 535 (1949).

[15] *Cunnyngham* v. *Shelby,* 136 Tenn. 176, 188 S.W. 1147, L.R.A. 1917B 572 (1916).

[16] *Fritts* v. *Palmer,* 132 U.S. 282 (1889). See also Annotation: *Foreign Corporation's Debts—Liability For,* 51 A.L.R. 376, 389 (1927).

by the law of the State in which it was incorporated, even though this question arises in another State.[17]

As a general rule, the courts of one State will not take jurisdiction of the internal affairs of a corporation incorporated in a different State.[18]

The Supreme Court of the United States has said:

> In order to hold a foreign corporation not licensed to do business in a state reponsible under the process of a local court the record must disclose that it was carrying on business there at the time of attempted service.[19]

If an association is doing business in a State, it may be sued there.[20]

Associations and Third Persons

If products in the custody of an association are damaged, for instance, by fire caused by the negligence of a third person, an association may recover in a suit for the damages suffered.[1] Again, if a person has entered into a contract with an association to buy a specified quantity of products, the association may sue for failure to comply with

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[17] *Farmers Educational and Cooperative Union of America, Minnesota Division* v. *Farmers Educational and Cooperative Union of America,* 207 Minn. 80, 289 N.W. 884 (1940); *Schwabe* v. *American Rural Credits Association,* 104 Neb. 46, 175 N.W. 673 (1919).

[18] *Farmers Educational and Cooperative Union of America, Minnesota Division* v. *Farmers Educational and Cooperative Union of America,* 207 Minn. 80, 289 N.W. 884 (1940).

[19] *International Harvester Co.* v. *Kentucky,* 234 U.S. 579 (1914). See also *Farmers Union Livestock Commission, Inc.* v. *District Court of Seventh Judicial District,* 93 Utah 181, 72 P.2d 448 (1937).

[20] *Patent Royalties Corp.*' v. *Land O'Lakes Creameries, Inc.,* 11 F. Supp. 103 (E.D.N.Y. 1935); *Eastern Livestock Cooperative Marketing Association* v. *Dickenson,* 107 F.2d 116 (4th Cir. 1939).

[1] *Louisville & Nashville Railroad Company* v. *Burley Tobacco Society,* 147 Ky. 22, 143 S.W. 1040 (1912).

the contract.[2] Conversely, if a cooperative enters into a contract to sell a specified quantity of products, ordinarily it would be required to answer in a suit for failure to abide by the contract.[3]

Cooperatives, like other concerns, may be compelled through the remedy of specific performance to perform contracts they have made. In one case, a cooperative was given the alternative of delivering its preferred stock in payment for warehouse facilities or of responding in damages.[4]

If an association makes an unconditional contract to sell a specified quantity of products, the contract is binding, and damages may be recovered for its breach unless its performance was prevented by law, an act of God such as floods, or the other party. Normally, exceptions should be included in selling contracts to cover contingencies, such as strikes, which may prevent the association from performing its contracts.

Cooperatives, like other business concerns, should exercise care to have the contracts they enter into with third persons clear and definite. Ambiguous contracts may lead to legal difficulties. This is well illustrated by a case in which the facts were somewhat equivocal.[5] The cooperative successfully contended that the defendant had purchased a carload of strawberries from it and was not acting simply as a broker in the sale of the strawberries. It was held also that a check which was received from the defendant and cashed by the association did not amount to an accord and satisfaction of the obligation because it was not submitted as "payment in full, nor was the remittance accompanied

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[2] *National Importing Co.* v. *California Prune and Apricot Growers, Inc.,* 85 Ind. App. 315, 151 N.E. 626 (1926); *Tustin Fruit Association* v. *Earl Fruit Company,* 6 Cal. Unrep. 37, 53 P. 693 (1898); *Consumers Cooperative Association* v. *Sherman,* 147 Neb. 901, 25 N.W. 2d 548 (1947).

[3] *Eskew* v. *California Fruit Exchange,* 203 Cal. 257, 263 P. 804 (1927).

[4] *Tri-State Terminal Company* v. *Washington Wheat Growers' Association,* 134 Wash. 519, 236 P. 75 (1925).

[5] *Three Rivers Growers' Association* v. *Pacific Fruit and Produce Company,* 159 Wash. 572, 294 P. 233, 235 (1930). See also on the question whether a check is satisfaction of an indebtedness, *Staples* v. *Growers' Finance Corporation,* 44 Ga. App. 451, 161 S.E. 675 (1931); *Work* v. *Associated Almond Growers of Paso Robles,* 102 Cal. App. 232, 282 P. 965 (1929); *Blue Ribbon Creamery* v. *Monk,* 168 Miss. 130, 147 So. 329 (1933).

by any act or declaration which would amount to a condition that the money tendered, if accepted, would be accepted as a satisfaction in full."

In another case, a seller of livestock unsuccessfully contended that an association had bought his livestock and had not acted as agent for their sale.[6]

Generally, if an agent exceeds his authority his principal is not bound. An association entered into a sales-agency contract with a distributor, covering the disposition of onions received by the association from its members. The distributor then entered into a contract with another party, purporting to authorize this party to make sales of onions. The association was not bound by this contract, as the distributor exceeded his authority as specified in the sales-agency contract, and the association, on learning of this fact, refused to acquiesce in the arrangement.[7]

If a cooperative is purchasing a business, including its goodwill, a stipulation should be included in the contract of purchase precluding the seller from engaging in the same business in the same town if the association desires to prevent the seller from doing so.[8] Otherwise, the general rule is that the seller is not barred from again engaging in business in the same town.[9]

In a number of cases, contracts entered into by milk bargaining cooperatives with milk distributors for the purpose of bringing about a market pool, so that all producers similarly situated will be paid the same price for their milk, have been held valid.[10]

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[6]*Eastern Livestock Cooperative Marketing Association* v. *Dickenson,* 107 F.2d 116 (4th Cir. 1939).

[7]*Eck Company* v. *Coachella Valley Onion Growers' Association,* 102 Cal. App. 1, 282 P. 408 (1929).

[8]*Dairymen's League Co-op Association, Inc.* v. *Weckerle,* 160 Misc. 866, 291 N.Y.S. 704 (1936).

[9]*Farmers' Cooperative Elevator of Fowler* v. *Sturgis & Sons,* 226 Mich. 437, 198 N.W. 191 (1924).

[10]*Stark County Milk Producers' Association* v. *Tabeling,* 129 Ohio St. 159, 194 N.E. 16, 98 A.L.R. 1393 (1934); *Dairy Cooperative Association* v. *Brandes Creamery,* 147 Ore. 488, 30 P. 2d 338 (1934), 147 Ore. 503, 30 P. 2d 344 (1934); *United States* v. *Rock Royal Cooperative, Inc.,* 307 U.S. 533 (1939); *Hood & Sons, Inc.* v. *United States,* 307 U.S. 588 (1939); *Connecticut Milk Producers' Association* v. *Brock-Hall Dairy Co., Inc.,* 122 Conn. 482, 191 A. 326 (1937).

Because a person's acts usually speak louder than his words, where a representative of an association took possession of warehouses covered by a contract, declarations made by the representative that the possession taken was only a qualified one did not have the effect of modifying the original contract.[11]

Whether money left with a bank results in the relation of bailor and bailee, or in that of debtor and creditor, depends upon the terms and conditions under which the money was left with the bank.[12] In the first instance, the association would be entitled to priority in the event of insolvency of the bank, while in the second case it would not; and an agreement for the bank to pay interest indicates a debtor-creditor relationship.[13]

While it has been held that a milk association may be enjoined from injuring a milk distributor in the operation of his business,[14] in another case, a court held that a milk distributor had no cause of action against a milk association for diverting milk from the milk distributor, unless the milk distributor could show that but for the acts of the association he would have obtained a sufficient supply of milk to meet his needs.[15]

Where a member of an association assigned his claim against the association for commodities delivered by him under his marketing contract, the member no longer had

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[11] *Tri-State Terminal Company* v. *Washington Wheat Growers' Association,* 134 Wash. 519, 236 P. 75 (1925).

[12] *Bank of Aurora* v. *Aurora Co-op Fruit Growing & Marketing Association,* 91 S.W. 2d 177 (Mo. App. 1936); *Oak Grove Farmers' Mutual Ins. Co.* v. *Almena State Bank of Almena,* 216 Wis. 182, 256 N.W. 696 (1934); *California Livestock Commission Co.* v. *Button,* 40 Ariz. 65, 9 P. 2d 414 (1932); *Florida Citrus Exchange* v. *Union Trust Co. of Rochester,* 244 App. Div. 68, 278 N.Y.S. 313 (1935).

[13] *Lewis* v. *Dark Tobacco Growers' Cooperative Association,* 247 Ky. 301, 57 S.W. 2d 8 (1933).

[14] *Pure Milk Producers Association of Greater Kansas City Territory* v. *Bridges,* 146 Kan. 15, 68 P.2d 658 (1937). See also *North Texas Producers Ass'n* v. *Young,* 308 F. 2d 325 (5th Cir. 1962), *certiorari denied,* 372 U.S. 929 (1963), and other cases discussed under "Antitrust Laws—Treble Damages," *supra,* at p. 284.

[15] *Hy-Grade Dairies* v. *Falls City Milk Producers' Association,* 261 Ky. 25, 86 S.W.2d 1046 (1935).

an interest in the claim which was subject to attachment.[16] A cooperative as a debtor can assert against an assignee of the debt a counterclaim based on the obligation of his assignor maturing subsequent to the assignment but before notice to the association of the claim.[17]

An association which is not a member of another cooperative may by contract become liable for obligations incurred by the other cooperative.[18]

In a case that illustrates the flexibility of the law of contracts, certain persons sold a stock of merchandise to a cooperative and agreed to look for payment only to the proceeds derived from sale of the merchandise which was to be sold "as rapidly as possible." The contract of sale was held valid.[19]

A jury found that a chick association had agreed to bear all losses which might arise from the purchase of chicks in case they developed a disease. Thus, the purchaser had the right to recover not only the purchase price of the chicks after their return, but also all other losses arising from their purchase.[20]

Hedging

Inasmuch as hedging is so widely practiced by cooperatives which handle agricultural commodities that are dealt in on futures markets or exchanges, a brief explanation of hedging appears in order. Hedging is regarded as a type of

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[16] *Stivers* v. *Steele (Burley Tobacco Growers Association),* 230 Ky. 700, 20 S.W.2d 717 (1929).

[17] *Maryland Cooperative Milk Producers* v. *Bell,* 206 Md. 168, 110 A. 2d 661 (1955).

[18] *New York Canning Crops Co-op Association, Inc.* v. *Slocum,* 126 Misc. Rep. 30, 212 N.Y.S. 534 (1925).

[19] *In re Blue Earth County Cooperative Company,* 139 Minn. 231, 166 N.W. 178 (1918).

[20] *Letres* v. *Washington Cooperative Chick Association,* 8 Wash.2d 64, 111 P.2d 594 (1941).

insurance.[1] When an association or a producer[2] of grain, for instance, desires to effect a hedge with respect to spot grain, or with respect to grain which is being produced, a sale is made of substantially a corresponding amount on a grain futures market or exchange. The spot grain, or the grain that is being produced, might be used for the making of delivery of the grain sold in the futures market, but this is seldom done.

Ordinarily, on the sale of the actual grain, the seller buys an amount of grain in the futures market equal to that previously sold in that market and thus the transaction in futures is closed. Normally, it is expected that if the price of grain declines, the "profits" made on the grain sold in the futures market will approximate the "loss" taken on the actual grain, so that the transaction in theory results in the seller obtaining a net price for his actual grain approximating the price at which the grain was sold in the futures market. When a handler of grain has contracted to deliver actual grain at a given time which he expects to acquire in the meantime, he may purchase a like amount of grain on a futures market and then on the purchase of the actual grain by him he sells the grain which he purchased in the futures market. In general, hedging contracts are valid.[3]

Futures markets, sometimes called commodity exchanges, have strict rules and regulations governing trading and all related matters. Also, the Secretary of Agriculture, under the Commodity Exchange Act, regulates futures trading in agricultural commodities through the Commodity Exchange Authority.

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[1]*Fraser* v. *Farmers' Cooperative Company,* 167 Minn. 369, 209 N.W. 33, *reargument denied,* 167 Minn. 369, 209 N.W. 913 (1926); *Benson-Stabeck Company* v. *Reservation Farmers' Grain Co.,* 62 Mont. 254, 205 P. 651 (1922).

[2]*Edgeley Cooperative Grain Company* v. *Spitzer,* 48 N.D. 406, 184 N.W. 880, 20 A.L.R. 1417 (1921).

[3]Annotation "Nature and validity of 'hedging' transactions on the commodity market," 20 A.L.R. 1422. See also *Makeever* v. *Barker,* 85 Ind. App. 418, 154 N.E. 692 (1926); *Clark* v. *Murphy,* 142 Kan. 426, 49 P. 2d 973 (1935); *South Carolina Cotton Growers' Co-op Association* v. *Weil,* 220 Ala. 568, 126 So. 637 (1929); *Fagerberg* v. *Phoenix Flour Mills Co.,* 50 Ariz. 227, 71 P.2d 1022 (1937).

Unincorporated Associations

Because some cooperatives are unincorporated, a discussion of their legal status and the rights and liabilities of their members is useful. An unincorporated association may be defined as a body of persons acting together, without a charter, but employing to a greater or less extent the forms and methods used by incorporated corporations, for the prosecution of some common enterprise.[1]

Characteristics

The liability of members of an unincorporated business association to third persons is the same as that of partners. A voluntary association, "composed of many members, adopting bylaws, having an associate name, and providing for certain officers and prescribing their duty, was but a partnership in the eyes of the law."[2] In the absence of a contractual provision or a statute on the subject, the death or withdrawal of a member does not dissolve the association.[3] A partnership, on the contrary, under such circumstances is dissolved by the death or withdrawal of a member.[4]

A corporation may sue or be sued in its own name. On the other hand, at common law, and in the absence of a statute, an unincorporated association cannot maintain an action in its own name but must sue in the names of all the members composing it, however numerous they may be.[5]

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[1] 7 C.J.S. Associations, §1.

[2] *Houghton* v. *Grimes,* 100 Vt. 99, 135 A. 15, 18 (1926).

[3] *Burke* v. *Roper,* 79 Ala. 138 (1885); *Lindemann & Hoverson Co.* v. *Advance Stove Works,* 170 Ill. App. 423 (1912); *Hossack* v. *Ottawa Dev. Association,* 244 Ill. 274, 91 N.E. 439 (1910).

[4] *Scholefield and Taylor* v. *Eichelberger,* 32 U.S. 586 (1833).

[5] *St. Paul Typothetae* v. *St. Paul Bookbinders' Union No. 37,* 94 Minn. 351, 102 N.W. 725 (1905); *Newton County Farmers' & Fruit Growers' Exchange* v. *Kansas City Southern Railway Co.,* 326 Mo. 617, 31 S.W.2d 803 (1930); *Old River Farms Company* v. *Roscoe Haegelin Company,* 98 Cal. App. 331, 276 P. 1047 (1929). If an unincorporated association fails to comply with statutory requirements for bringing suit under the association name, it lacks capacity to sue in this form. *Kadota Fig Association of Producers* v. *Case-Swayne Co.,* 73 Cal. App. 2d 815, 167 P.2d 518 (1946). Nor can it file a cross complaint in an action filed against it. *Case*

Likewise, such an association in the absence of a statute cannot be sued in its name. The individual members must be sued.[6]

A corporation may take title to property in its own name, but an unincorporated association, in the absence of a statute, is ordinarily incapable as an organization of taking or holding either real or personal property in its name.[7]

How Formed

Statutes have been passed in some States expressly authorizing individuals to unite as a voluntary association under a distinctive name. However, as a rule, unincorporated or voluntary associations are organized independent of statute. They are generally formed under the common law right of contract. Just as A and B may enter into a contract with reference to doing some lawful act, so a larger number may associate for the accomplishment of a lawful objective.

Provision may be made for any matter that is a legitimate subject of contract. The qualifications of members may be prescribed, and causes for expulsion may be specified. A constitution is usually adopted which states the purposes of the association and other fundamental propositions relative to the organization. Bylaws are also usually adopted which prescribe the operating rules and the manner in which the objectives of the association are to be attained. The constitution and the bylaws, or either of them, constitute a contract binding all those who agree to them.

"The articles of agreement of such an association, whether called a 'constitution,' 'charter,' 'bylaws,' or any

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v. *Kadota Fig Association of Producers,* 207 P.2d 86 (Cal. D.C. of App. 1949).

[6] *Allis-Chalmers Co.* v. *Iron Molders' Union No. 125,* 150 F. 155 (E.D. Wis. 1906); *Board of Railroad Commissioners* v. *Reed,* 102 Mont. 382, 58 P. 2d 271 (1936).

[7] *Philadelphia Baptist Association* v. *Hart's Executors,* 4 Wheat. 1, 17 U.S. 1 (1819); *Idaho Apple Growers Association* v. *Brown,* 50 Idaho 34, 293 P. 320 (1930), 51 Idaho 540, 7 P.2d 591 (1932). See also Annotation, *Power and capacity of members of unincorporated association, lodge, society, or club to convey, transfer, or encumber association property,* 15 A.L.R. 2d 1451.

other name, constitute a contract between the members which the courts will enforce if not immoral or contrary to public policy or the law of the land."[8] This language was quoted approvingly in a Kansas case[9] involving an antihorse-thief association. It appears to state the general rule.[10] Thus, because a voluntary association rests on contract, the rights or liabilities of members among themselves are to be determined by the contracts involved in accordance with common law principles as modified or supplemented by statutes. And in the absence of a constitution or bylaws, the courts will apply the legal rules of contract for ascertaining the rights of the parties, weight being given to any usages or customs that may have been followed by the association.[11]

For a constitution and bylaws, or either of them, to constitute a contract between an association and one claiming or alleged to be a member, he must have agreed to them, either by signing papers containing the constitution and bylaws, or by assenting to them in some other way.[12] If one, in joining an association, signs its constitution and bylaws or assents to them in some other way and thus agrees to be bound by them, he is in no position to complain because he is required to comply with the rules and regulations of the association to which he agreed or because he is expelled from the association in accordance with them.[13]

In a case involving the New York Stock Exchange, it appeared that a former member had been expelled for cause. The court of appeals said:

> The interest of each member in the property of the association is equal, but it is subject to the constitution and bylaws, which are the basis on which is founded the association. They express the contract by which each member has consented to be bound, and which measures his duties, rights, and privileges as such. It seems

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[8] *Brown* v. *Stoerkel,* 74 Mich. 269, 41 N.W. 921, 923, 3 L.R.A. 430 (1889).

[9] *McLaughlin* v. *Wall,* 86 Kan. 45, 119 P. 541 (1911).

[10] *Kalbitzer* v. *Goodhue,* 52 W.Va. 435, 44 S.E. 264 (1903).

[11] *Ostrom* v. *Greene,* 161 N.Y. 353, 55 N.E. 919 (1900).

[12] *Austin* v. *Searing,* 16 N.Y. 112, 69 Am. Dec. 665, and note (1857).

[13] *State ex rel. Rowland* v. *Seattle Baseball Association,* 61 Wash. 79, 111 P. 1055 (1910).

most clear to me that this constitution and the bylaws derive a binding force from the fact that they are signed by all the members, and that they are conclusive upon each of them in respect of the regulations of the mode of transaction of his business, and of his right to continue to be a member.[14]

Admission of Members in Unincorporated Associations

It has been previously stated that an unincorporated association may prescribe the qualifications of members. It cannot be compelled to admit as members persons whom it chooses to exclude.[15]

In other words, the whole matter of the admission of members rests with the association.[16] With respect to the admission of members, it would seem that, in general, the rules applicable to incorporated associations would also apply here. This is well illustrated in the case of farmers' telephone lines. The question of whether membership can be sold with the farm in such instances has arisen. It has been held that an association has the right to control its membership, and a purchaser of a farm merely by virtue of his warranty deed does not become a member of such a telephone company.[17]

Membership Nontransferable

Membership in an unincorporated association is not transferable unless the constitution or bylaws provide that it shall be.[18] The interest of a member in such an association is not devisable or transmissible, and his estate re-

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[14] *Belton* v. *Hatch,* 109 N.Y. 593, 17 N.E. 225, 226, 4 Am. St. Rep. 495 (1888).

[15] *Richardson* v. *Union Congregational Society of Francestown,* 58 N.H. 187 (1877).

[16] See "Who May Become Members," *supra,* p. 90.

[17] *Cantril Telephone Co.* v. *Fisher,* 157 Iowa 203, 138 N.W. 436, 42 L.R.A. (N.S.) 1021 (1912). See also cases and discussion under "Membership—How Acquired," *supra,* p. 87, and "Who May Become Members," *supra,* p. 90.

[18] *Moore* v. *Hillsdale County Telephone Co.,* 171 Mich. 388, 137 N.W. 241 (1912); *McMahon* v. *Rauhr,* 47 N.Y. 67 (1871).

ceives nothing therefrom on his death[19] in the absence of a contractual or statutory provision to the contrary.

Control of an Unincorporated Association

In the absence of an agreement to the contrary, within the scope of the objects for which an association was formed, whether such objects are mentioned in the constitution or other papers defining the objects of the association or are necessarily implied from them, a majority of the members possess authority to control the action of the association.[20] The majority controls, however, only while the association is doing those things for which it was organized. If it is desired to have the association do something different from that for which it was formed, unanimous consent is necessary.[21]

Notice of Meetings

If the constitution or bylaws provide how members shall be notified of meetings, they must be followed.[22] In general, all members are entitled to notice of all meetings and of the matters to be considered at such meetings. If matters of an unusual character are to be considered at a meeting, it is particularly important that the nature of the business be brought to the attention of each member.[23]

Unincorporated Associations and Third Persons

The liability of the members of an association that is not engaged in business has been said to rest upon the principles

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[19]*Sommers* v. *Reynolds,* 103 Mich. 307, 61 N.W. 501 (1894); *Mason* v. *Atlanta Fire Co.,* 70 Ga. 604, 48 Am. Rep. 585 (1883).

[20]4 Cyc. 310; *Goller* v. *Stubenhaus,* 77 Misc. 29, 134 N.Y.S. 1043 (1912); *Ace Bus Transportation Company* v. *South Hudson County Boulevard Bus Owners' Association,* 118 N.J. Eq. 31, 177 A. 360, *affirmed in* 119 N.J. Eq. 37, 180 A. 835 (1935).

[21]*Abels* v. *McKeen,* 18 N.J. Eq. 462 (1867).

[22]*Kuhl* v. *Meyer,* 42 Mo. App. 474 (1890).

[23]*State ex rel Rowland* v. *Seattle Baseball Association,* 61 Wash. 79, 111 P. 1055 (1910).

of agency.[24] An illustration will make this clearer. The constitution of an association stated that it was formed to stimulate interest in the breeding of pigeons and bantams. It gave the board of directors charge of all public exhibitions of the society and required each member to pay an initiation fee and an annual assessment. An exhibition was held, and premiums were offered. The expenses were greater than the receipts. Certain of the members paid the bills. They then brought suit against other members of the association to compel them to contribute their respective proportions of the loss sustained. The court said:

> Mere membership would not bind anybody for any further payment than the initiation fee and annual assessment; but such members as participated in a vote to incur further expenses for an exhibition with premiums, or as assented to be bound by such vote, would be bound thereby.[25]

In other words, only those members were liable who authorized the exhibition with premiums or who later ratified the act of holding such an exhibition. The other members were not liable.

The members of a building committee of an unincorporated religious society ordered lumber from a dealer for the building of a church. A dispute arose, and the dealer brought suit against the members of the building committee, and won. In holding the defendants liable, the court said:

> The church organization had no legal existence. It could neither sue nor be sued. The members of the society were not partners. Those of the society who were actually instrumental in incurring the liabilities for it are liable as either principals or agents having no legal principal behind them. Members of the society who either authorized or ratified the transactions are liable, while those who did not are exempt from liability.[26]

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[24] 7 C.J.S. Associations, sec. 32.

[25] *Ray* v. *Powers,* 134 Mass. 22 (1883).

[26] *Clark* v. *O'Rourke,* 111 Mich. 108, 69 N.W. 147, 148, 66 Am. St. Rep. 389 (1896).

Authorities apparently agree that, if a particular debt or obligation was necessarily incurred for the express purpose for which the association was formed, each member of the association is liable. In a South Dakota case, the following language was used with reference to this situation:

> *** each member of an unincorporated or voluntary association is liable for the debts thereof incurred during his period of membership, and which had been necessarily contracted for the purpose of carrying out the objects for which the association was formed.[27]

In another case, those in charge of an association were expected to make advances on the delivery of commodities, and to make other disbursements. The association had no capital. Those in charge of the association were held to have had implied authority to borrow money, with resulting liability to the members.[28]

The question sometimes arises as to the liability of officers of an unincorporated association for debts contracted by them for the association. In the case of a business association, the officers ordinarily are personally liable for its debts, but if they include a provision in the contract creating the obligation that they are not personally liable, then they are free from personal responsibility for the debt.

The secretary of the North Dakota Farm Bureau Federation, an unincorporated organization, brought suit against the federation and its officers to recover for services rendered by him for the federation. It was held that, as the officers of the federation stipulated that they were not to be bound individually, they were not individually liable upon the contract made with the secretary.[29]

Growers of sweetpotatoes in Arkansas took steps to form an incorporated cooperative for the purpose of curing and preserving potatoes. No corporation was formed, but per-

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[27] *Lynn* v. *Commercial Club of Witten,* 31 S.D. 401, 141 N.W. 471 (1913). See also *Little Rock Furniture Mfg. Co.* v. *Kavanaugh,* 111 Ark. 575, 164 S.W. 289, 51 L.R.A. (N.S.) 406, Ann. Cas. 1916A 848 (1914); *Schumacher* v. *Sumner Tel. Co.,* 161 Iowa 326, 142 N.W. 1034, Ann. Cas. 1916A 201 (1913); *Dinsmore* v. *J. H. Calvin Co.,* 214 Ala. 666, 108 So. 583 (1926).

[28] *Tomlin* v. *Petty,* 244 Ky. 542, 51 S.W.2d 663 (1932).

[29] *Fuller* v. *Reed,* 55 N.D. 707, 215 N.W. 147 (1927).

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sons selected as officers of the association by those interested in forming it executed two promissory notes in the name of the Ashdown Potato Curing Association, signing their own names as president and secretary, respectively. The money was used for building a potato-curing house. The venture failed. In connection with the project, subscription lists for stock were circulated. A suit was brought on the notes against the two officers of the association and about 60 other persons who were alleged to have been interested. The question for decision was who were liable on the notes. The Supreme Court of Arkansas in passing on this question said:

> *** it was a voluntary, unincorporated association, in effect a partnership, and *** the only question in the case was the identity of the persons who composed the association at the time the notes in suit were executed.[30]

This case illustrates how those interested in the formation of an incorporated association may, if the plans for incorporation fail, be held liable as members of an unincorporated association.

If an unincorporated association is engaged in business, the members are liable as partners to third persons. This obligation is imposed by law on the members of such an association, and it is immaterial what the rules of the association provide on the subject of liability.[31]

Suit was brought against an unincorporated cooperative, and certain of its members, to recover the sale price of goods purchased by the association for use in its business. The association was composed of 19 members. The plaintiff obtained a judgment against two of the members of the association, and they appealed on the ground that they could not be held individually responsible. In affirming the judgment of the lower court, the Court of Appeals of California found that the case was brought within the rule announced in 5 Corpus Juris 1362, 1363, as follows:

> While as between the members of an unincorporated association, each is bound to pay only his numerical

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[30] *Harris* v. *Ashdown Potato Curing Association,* 171 Ark. 399, 284 S.W. 755, 759 (1926).

[31] *Bennett* v. *Lathrop,* 71 Conn. 313, 42 A. 634, 71 Am. St. Rep. 222 (1899).

proportion of the indebtedness of the concern, yet as against the creditors, each member is individually liable for the entire debt, provided, of course, the debt is of such a nature and has been so contracted as to be binding on the association as a whole***. An unincorporated association organized for business or profit is in legal effect a mere partnership so far as the liability of its members to third persons is concerned; and accordingly each member is individually liable as a partner for a debt contracted by the association.[32]

The association involved in this case was organized for business purposes. This case illustrates one of the serious objections to unincorporated associations and, in turn, emphasizes one of the great advantages of an incorporated association in which generally the members are not liable for the debts of the association.

Money Must Be Used for Purpose Specified

The rule that money can be used only for the purpose for which contributed appears settled. A retail butchers' protective association was organized with a constitution which specified the purposes for which money could be used. Through dues paid by the members, a fund of $1,800 was accumulated. There were 24 members of the association. At a regular meeting, 20 were present, and by a vote of 12 to 8 an order was passed to distribute all the money in the treasury except $100 among the members. Certain of the members who opposed this use of the money obtained an injunction preventing the distribution of the money, and the court held that although a majority of the members present at the meeting had voted in favor of the distribution, yet it could not lawfully be diverted from the purpose for which contributed, as set forth in the constitution.[33]

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[32] *Webster* v. *San Joaquin Fruit & Vegetable Growers' Protective Association,* 32 Cal. App. 264, 162 P. 654, 655 (1916). See also *Burks* v. *Weast,* 67 Cal. App. 745, 228 P. 541 (1924); *Case* v. *Kadota Fig Association of Producers,* 207 P.2d 86 (Cal. D.C. of App. 1949) (dictum).

[33] *Kalbitzer* v. *Goodhue,* 52 W. Va. 435, 44 S.E. 264 (1903).

Where certain members of an association formed a corporation, this did not operate to transfer the assets of the association to the corporation, over the objection of some of the members.[34] "The vote must be for some purpose for which the money was contributed," said a New Jersey court. "A majority cannot devote the money of the minority, or even of a single member, to any other purpose without his consent."[35]

Expulsion of Members

It was pointed out earlier in this discussion on unincorporated associations that the rights of the members between themselves was a contractual one and that the constitution and bylaws, or either of them, constituted a contract between the members. It follows that if the constitution or bylaws assented to by the members state causes for expulsion from the association, ordinarily the courts would afford no relief if a member were expelled in good faith for such a cause.[36] This is undoubtedly the general rule.[37] However, all rules of the association relative to expulsion must be followed.[38]

The constitution or bylaws of the association may place the entire matter of disciplining, suspending, or expelling members in a committee or like body.[39] Such a provision in the constitution or bylaws, like other legal provisions in such instruments, is binding upon all members assenting to them.

In a case involving an unincorporated communal society, the organization papers of which did not specify any causes

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[34]*Hamaty* v. *St. George Ladies Society,* 280 Mass. 58, 181 N.E. 775 (1932). See also *Strong* v. *Los Nietos & Ranchito Walnut Growers' Association,* 137 Cal. 607, 70 P. 734 (1902).

[35]*Abels* v. *McKeen,* 18 N.J. Eq. 462 (1867).

[36]*Connelly* v. *Masonic Mutual Benefit Association,* 58 Conn. 552, 20 A. 671, 9 L.R.A. 428, 18 Am. St. Rep. 296 (1890); 7 C.J.S. Associations, sec. 25.

[37]See preceding footnote and note in 9 L.R.A. 428.

[38]*Farmer* v. *Board of Trade of Kansas City,* 78 Mo. App. 557 (1899); *Kelly* v. *Grand Circle Women of Woodcraft,* 40 Wash. 691, 82 P. 1007 (1905); 7 C.J.S. Associations, sec. 25. See also text and cases cited at footnote 195, "Stock and Nonstock Associations," p. 79.

[39]*Harris* v. *Aiken,* 76 Kan. 516, 92 P. 537, 123 Am. St. Rep. 149 (1907).

for expulsion, it was held, where a member was expelled without just cause, that he was entitled to recover a pro rata part of "his heretofore undivided interest in the property" of the society which had been acquired during his membership.[40]

It has been said with reference to unincorporated associations that "*** courts never interfere, except to ascertain whether or not the proceeding was pursuant to the rules and laws of the society, whether or not the proceeding was in good faith, and whether or not there was anything in the proceeding in violation of the laws of the land."[41]

Withdrawing or Expelled Members Receive Nothing

In the absence of a contract or statute on the subject, the rule appears to be settled that those who withdraw[42] or are expelled[43] from an unincorporated association are not entitled to compensation for their interest in the association and that they thereby lose all rights in the property of the association.[44] Although a majority of the members of an association withdraw, the right of those who remain to continue the association appears clear, and this right carries with it the right to the property of the association.[45]

"It has been many times decided," said a Michigan court, "that persons who withdraw from a voluntary association are not entitled to any portion of its property, and that those who remain have the right to the property of the association and its use so long as any of the members remain, and clearly withdrawing members ought not to decide

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[40] *Nachtrieb* v. *The Harmony Settlement,* Federal Case No. 10,003, 17 Fed. Cases 1139 (1855).

[41] *Kelly* v. *Grand Circle Women of Woodcraft,* 40 Wash. 691, 82 P. 1007, 1008 (1905); *Burt* v. *Oneida Community, Ltd.,* 137 N.Y. 346, 33 N.E. 307, 19 L.R.A. 297; 138 N.Y. 649, 34 N.E. 288 (1893). See also 4 Am. Jur., p. 471, sec. 25.

[42] *Richardson* v. *Harsha,* 22 Okla. 405, 98 P. 897 (1908). See also *Schwartz* v. *Duss,* 187 U.S. 8 (1902).

[43] *Missouri Bottlers' Association* v. *Fennerty,* 81 Mo. App. 525 (1899); 5 C.J. 1360; 19 R.C.L. 1267.

[44] Cases cited above.

[45] *McFadden* v. *Murphy,* 149 Mass. 341, 21 N.E. 868 (1889); *Altmann* v. *Benz,* 27 N.J. Eq. 331 (1876).

the right of those not withdrawing to continue the association."[46]

Dissolution

In the absence of a statutory or contractual provision to the contrary, an unincorporated association can be dissolved only by unanimous consent of the members.[47] Upon the dissolution of an unincorporated association, unless otherwise provided by its rules, its property after payment of its debts is usually distributed pro rata among those who were members at the time of such dissolution.[48]

Statutes Affecting Cooperatives

There is no Federal statute conferring general regulatory or supervisory powers over agricultural cooperatives. As pointed out in the discussion of the Capper-Volstead Act,[1] in certain circumstances the Secretary of Agriculture may institute proceedings against associations under that Act. Again, if an association is engaged in abnormal acts or transactions, it may be subject to prosecution under the antitrust statutes. Such associations, if they engage in unfair competition, are subject to action by the Federal Trade Commission.[2] They are likewise amenable to other Federal statutes of general application, such as the Agricultural Fair Practices Act of 1967,[3] the many statutes regulating the

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[46] *Walters* v. *Pittsburgh & Lake Angeline Iron Co.*, 201 Mich. 379, 167 N.W. 834, 837, 1 A.L.R. 624 (1918).

[47] *Sommers* v. *Reynolds*, 103 Mich. 307, 61 N.W. 501 (1894); *Parks* v. *Knickerbocker Trust Co.*, 137 App. Div. 719, 122 N.Y.S. 521 (1910). See also *Hamaty* v. *St. George Ladies Society*, 280 Mass. 58, 181 N.E. 775 (1932); *Strong* v. *Los Nietos & Ranchito Walnut Growers' Association*, 137 Cal. 607, 70 P. 734 (1902).

[48] Cases last cited. But *cf. Attinson* v. *Consumer-Farmer Milk Cooperative, Inc.*, 94 N.Y.S.2d 891 (1950).

[1] See "Capper-Volstead Act," at p. 293.

[2] 38 Stat. 717, 15 U.S.C. 41.

[3] 7 U.S.C. 2301-2306.

marketing of farm products,[4] and the Robinson-Patman Act,[5] which prohibits, among other things, unjustifiable price discriminations.[6]

Although many States have bureaus or agencies that provide service to agricultural cooperatives, there appear to be no State statutes providing for their regulation and supervision. In general, the situation with respect to these cooperatives is comparable to that of other corporations engaged in private business.

A statute, whether State or Federal, covering persons or organizations engaged in business of a particular type, is generally applicable to cooperatives engaged in such busi-

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[4]For a discussion of the legal basis for these statutes and a listing of them, see Brooks, *The Wide Range of Regulation,* 1954 Yearbook of Agriculture, p. 255 *et. seq.* See also Brooks, *Marketing of Farm Products Under Some of the Federal Regulatory Statutes,* 6 S.C.L.Q. 247 (1954); Brooks, *Federal Regulation of the Marketing of Farm Products,* 30 Rocky Mt. L. Rev. 457 (1958); Griffin, *Federal Marketing Regulations,* California Farm & Ranch Law 213 (1967). See also Say and Fourt, *State Marketing Regulations,* California Farm & Ranch Law 243 (1967).

[5]49 Stat. 1526, 15 U.S.C. 13.

[6]For cases involving cooperatives: (1) before the National Labor Relations Board, see *N.L.R.B.* v. *Enid Coop. Creamery Association,* 169 F. 2d 986 (10th Cir. 1948); *N.L.R.B.* v. *Edinburg Citrus Association,* 147 F. 2d 353 (5th Cir. 1945); *Idaho Potato Growers, Inc.* v. *N.L.R.B.,* 144 F.2d 295 (9th Cir. 1944); (2) in reparation cases under the Perishable Agricultural Commodities Act, see *California Fruit Exchange* v. *Henry,* 89 F. Supp. 580 (W.D. Pa. 1950); *Maine Potato Growers, Inc.* v. *Jos. Martinelli & Company, Inc.,* 3 A.D. 997 (1944); (3) in cases involving the Fair Labor Standards Act, see *Farmers Reservoir & Irrigation Co.* v. *McComb,* 337 U.S. 755 (1949); *Puerto Rico Tobacco Marketing Cooperative Association* v. *McComb,* 181 F.2d 697 (1st Cir. 1950); *Meeker Cooperative Light & Power Association* v. *Phillips,* 158 F.2d 698 (8th Cir. 1946); *Holly Hill Fruit Products, Inc.* v. *Addison,* 136 F.2d 323 (5th Cir. 1943); *Stephens* v. *Cotton Producers Association,* 117 F. Supp. 517 (N.D. Ga. 1953); *Dallum* v. *Farmers Cooperative Trucking Association,* 46 F. Supp. 785 (D. Minn. 1942); *Holt* v. *Barnesville Farmers Elevator Co.,* 52F. Supp. 468 (D. Minn. 1943); and (4) in cases involving World War War II regulations, see *Great Northern Co-op Association* v. *Bowles,* 146 F.2d 269 (Emer. Ct. App. 1944); *Land O'Lakes Creameries, Inc.* v. *McNutt,* 132 F. 2d 653 (8th Cir. 1943); *Porter* v. *Cokato Cooperative Creamery Association,* 65 F. Supp. 974 (D. Minn. 1946); *Bowles* v. *Fruit Growers Co-op,* 61 F. Supp. 745 (E.D. Wis. 1945); *Bowles* v. *Co-operative G.L.F. Farm Products,* 53 F. Supp. 413 (W.D.N.Y. 1943); *Bowles* v. *Sebastopol Berry Growers Association,* 4 F.R.D. 502 (N.D. Calif. 1945).

ness, unless they are specifically excepted by statute or court decisions.[7]

Under many State cooperative statutes, cooperatives, like other private corporations, are required to make reports to a State official.[8]

If a cooperative functions as a licensed public warehouseman, it is subject to regulation by the State or Federal Government, as the case may be. However, it has been held that a warehouse licensed under the Federal act is free from regulation under the State act.[9] Likewise, farmers' mutual insurance associations may be subject to State insurance statutes, and to supervision by a State agency.

A cooperative financed with loans from the Rural Electrification Administration that engaged in the generation, transmission, and interstate sale of electric energy at wholesale to its members, consisting of electric cooperatives and a State governmental agency, was not a "public utility" within the Federal Power Commission's jurisdiction under the Federal Power Act.[10]

For years there has been controversy and much difference of opinion as to whether electric and telephone cooperatives are public utilities and whether they should be regulated by a State public service commission.[11] This is an

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[7]*State ex rel. Van Winkle* v. *Farmers Union Cooperative Creamery,* 160 Ore. 205, 84 P.2d 471 (1938); *West Central Producers Cooperative Association* v. *Commissioner of Agriculture,* 124 W.Va. 81, 20 S.E.2d 797 (1942); *Farmers Co-op Equity Union Shipping Association* v. *Public Service Commission,* 245 Wis. 143, 13 N.W.2d 507 (1944); *I.C.C.* v. *Milk Producers Marketing Company,* 405 F.2d 639 (10th Cir. 1969); *I.C.C.* v. *Big Sky Farmers & Ranchers Marketing Cooperative of Montana,* 451 F. 2d 511 (9th Cir. 1971). See annotation, *Licensing Buyers of Farm Produce,* 117 A.L.R. 347.

[8]See, for example, Minn. Stats. Ann. §308.71.

[9]*In re Farmers Cooperative Association,* 69 S.D. 191, 8 N.W. 2d 557 (1943).

[10]*Salt River Project Agricultural Improvement and Power Dist.* v. *Federal Power Commission,* 391 F.2d 470 (D.C. Cir. 1968), *certiorari denied,* 393 U.S. 857 (1968).

[11]See generally Annotation, *Cooperative as Public Utility,* 132 A.L.R. 1495-1514 (1940). See also Packel, *The Organization and Operation of Cooperatives,* 4th ed., American Law Institute (1970), p. 270, for a discussion and analysis of many of the cases on this subject. Early cases include *Limestone Rural Telephone Co.* v. *Best,* 56 Okla. 85, 155 P. 901 (1916); *State* v. *Southern Elkhorn Telephone Co.,* 106 Neb. 342, 183 N.W. 562

issue resolved by the law of the particular State. Now, in more than half of the States, electric cooperatives are regulated by public service commissions. Telephone cooperatives are subject to commission jurisdiction in almost all States. This regulation or jurisdiction may cover such matters as territory, adequacy of service, rates, approval of financing, or construction. In a number of instances, electric cooperatives found it necessary to seek the legislation that authorized State commission regulation of some or all aspects of their operations in return for varying degrees of territorial protection and integrity.[12]

Another class of cases arises in connection with Federal and State motor-carrier acts, and the question usually involves whether a particular association is functioning as a

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(1921); *People ex rel. Knowlton* v. *Orange County Farmers' and Merchants' Association,* 56 Cal. App. 205, 204 P. 873 (1922); *State ex rel. Lohman & Farmers' Mutual Telephone Co.* v. *Brown,* 323 Mo. 818, 19 S.W. 2d 1048 (1929); *Gilman* v. *Somerset Farmers' Coop. Telephone Co.,* 129 Me. 243, 151 A. 440 (1930); *In re Harrison Rural Electrification Association, Inc.,* 24 P.U.R. (N.S.) 7 (1938); *Inland Empire Rural Electrification, Inc.* v. *Department of Public Service of Washington,* 199 Wash. 527, 92 P. 2d 258 (1939); *Garkane Power Co., Inc.* v. *Public Service Commission,* 98 Utah 466, 100 P. 2d 571 (1940). Following the *Garkane* case, there was no jurisdiction over electric cooperatives in Utah until they were brought under commission jurisdiction by an amendment in 1965 (Utah Code Ann. §54-4-25) and the Garkane Power Company requested and received a certificate of convenience and necessity from the State commission. See Beard, *Regulation of Rural Electrical Cooperatives,* 1966 Utah L. Rev. 102. See also *Dairyland Power Cooperative* v. *Brennan,* 248 Minn. 556, 82 N.W.2d 56 (1957); *Dickinson* v. *Maine Public Service Co.,* 223 A.2d 435 (Me. 1966); *Community Public Service* v. *New Mexico Public Service Commission and Otero County Electric Cooperative,* 76 N.M. 314, 414 P. 2d 675 (1966); *Montana-Dakota Utilities Co.* v. *Johanneson,* 153 N.W.2d 414 (N.Dak. 1967). *Louisiana Power and Light Co.* v. *Louisiana Public Service Commission,* 205 La. 596, 197 So.2d 638 (1967); *Central Louisiana Electric Co.* v. *Louisiana Public Service Commission,* 251 La. 532, 205 So.2d 389 (1967); *Central Louisiana Electric Co.* v. *Louisiana Public Service Commission,* 253 La. 553, 218 So.2d 592 (1969).

[12]See *Legal Aspects of Territorial Protection for REA-Financed Cooperatives,* Office of the General Counsel, U.S. Dept. Agr. (Jan. 1970). See also talks by Louis Gorrin, *Factors for Consideration Re: Commission Jurisdiction over Cooperatives,* Western Hills, Okla., July 28, 1969, and *Territorial Integrity and Commission Jurisdiction,* Milwaukee, Wis., Mar. 24, 1970; William C. Wise, *Legal Basis for Special Classification of Rural Electric Cooperatives—Regulation, Wholesale Rates, Taxation and Other Purposes,* Atlanta, Ga. (1966).

for-hire or private carrier. Here, again, the terms of the applicable statutes will frequently indicate the answer to the question.

An association of producers engaged in intrastate hauling by motor vehicles of the agricultural products of its members and in the hauling of farm supplies for them may be regulated,[13] but in some of the States the statutes regulating motor carriers specifically exempt such associations.[14] Such exemptions are valid.[15] On the other hand, where there is no statutory exemption for such associations or unless the statute is written in such a way as to be inapplicable to cooperatives, they are subject to motor-carrier acts.[16] The exemption of motor vehicles used exclusively in the transportation of agricultural or dairy products from the operation of a State statute requiring for-hire carriers to obtain licenses has been upheld, regardless of whether the trucks are the property of the producer of such products or of another.[17]

Farmers engaged in the hauling of their own products appear either to be exempt from the various State statutes regulating motor carriers, or such statutes by their terms are not applicable to them. The fact that individual farmers are not subject to a motor carrier act has not been the basis for exemption for an association of such farmers engaged in the hauling of their products collectively.[18] It has been held

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[13]See "Persons hauling commodities for cooperative purchasing or marketing associations, or their members, as common carriers," 98 A.L.R. 226; "Jurisdiction of public service commission over carriers transporting by motor trucks or buses," 103 A.L.R. 268; "Validity and applicability of statutes relating to use of highway by private motor carriers and contract motor carriers for hire," 109 A.L.R. 550; 175 A.L.R. 1333; "Construction and application of exemption or exception provisions of statutes requiring registration of motor vehicles, etc.," 91 A.L.R. 422.

[14]See Bowser, Jr., *State Motortruck Exemptions of Interest to Farmer Cooperatives,* FCS Service Report 60, Farmer Cooperative Service, U.S. Dept. Agr. (1963).

[15]*Baker* v. *Glenn,* 2 F. Supp. 880 (E.D. Ky. 1933).

[16]*Parlett Co-operative, Inc.* v. *Tidewater Lines, Inc.,* 164 Md. 405, 165 A. 313 (1933); *North Shore Fish & Freight Co.* v. *North Shore Business Men's Trucking Association,* 195 Minn. 336, 263 N W. 98 (1935).

[17]*Aero Mayflower Transit Co.* v. *Georgia Public Service Commission,* 295 U.S. 285 (1935). But see *Smith* v. *Cahoon,* 283 U.S. 533 (1931).

[18]See *Rutledge Cooperative Association, Inc.* v. *Baughman,* 153 Md. 297, 138 A. 29, 56 A.L.R. 1042 (1927); *Madonna & Shawsville Co-operative*

that one employed by a cooperative to haul only the products of its members is not a common carrier;[19] but it has also been held otherwise.[20]

With respect to Federal law, the Motor Carrier Act, 1935, as amended, provides:

> Sec. 203. *** (b) Nothing in this part, except the provisions of section 204 relative to qualifications and maximum hours of service of employees and safety of operation or standards of equipment shall be construed to include *** (4a) motor vehicles controlled and operated by any farmer when used in the transportation of his agricultural (including horticultural) commodities and products thereof, or in the transportation of supplies to his farm; or (5) motor vehicles controlled and operated by a cooperative association as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended, or by a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined, but any interstate transportation performed by such a cooperative association or federation of cooperative associations for nonmembers who are neither farmers, cooperative associations, nor federations thereof for compensation, except transportation otherwise exempt under this part, shall be limited to that which is incidental to its primary transportation operation and necessary for its effective performance and shall in no event exceed 15 per centum of its total interstate transportation services in any fiscal year, measured in terms of tonnage: *Provided,* That, for the purposes

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Co. of Harford County, Inc. v. *West,* 168 Md. 95, 176 A. 611 (1935).

[19] *Dairymen's Coop. Sales Association* v. *Public Service Commission,* 318 Pa. 381, 177 A. 770, 98 A.L.R. 218 (1935). See also *Michigan Public Utilities Commission* v. *Duke,* 266 U.S. 570, 36 A.L.R. 1105 (1925). But see *Affiliated Service Corporation* v. *Public Utilities Commission of Ohio,* 127 Ohio St. 47, 186 N.E. 703, 103 A.L.R. 264 (1933).

[20] *West* v. *Western Maryland Dairy,* 150 Md. 641, 135 A. 136 (1926), *writ of error dismissed in* 274 U.S. 765 (1927); *West* v. *Tidewater Express Lines,* 168 Md. 581, 179 A. 176 (1935); *Public Utilities Commission of Ohio* v. *Boughtonville Farmers' Exchange Co.,* 40 Ohio App. 395, 178 N.E. 859 (1931); *Davis* v. *People,* 79 Colo. 642, 247 P. 801 (1926).

hereof, notwithstanding any other provision of law, transportation performed for or on behalf of the United States or any agency or instrumentality thereof shall be deemed to be transportation performed for a nonmember: *Provided further*, That any such cooperative association or federation which performs interstate transportation for nonmembers who are neither farmers, cooperative associations, nor federations thereof, except transportation otherwise exempt under this part, shall notify the Commission of its intent to perform such transportation prior to the commencement thereof: *And provided further*, That in no event shall any such cooperative association or federation which is required hereunder to give notice to the Commission transport interstate for compensation in any fiscal year of such association or federation a quantity of property for nonmembers which, measured in terms of tonnage, exceeds the total quantity of property transported interstate for itself and its members in such fiscal year ***.[21]

If an agricultural cooperative intends to perform interstate transportation for compensation for nonmembers who are neither farmers, cooperatives, nor federations, it must first notify the Interstate Commerce Commission in writing of its intent to do so.[22] Such transportation is limited to 15 percent of total interstate transportation measured in terms of tonnage. It is also restricted to that which is incidental to the cooperative's primary transportation operation and necessary to its effective performance. Where a cooperative's transportation of nonmember, nonfarm products and supplies did not exceed 15 percent of its total interstate tonnage and was incidental and necessary to its farm-related transportation, and its nonmember business did not exceed member business, the requirements of section 203(b)(5)

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[21]49 Stat. 545, 49 U.S.C. 303, as amended by the Transportation Act of 1940, 54 Stat. 921; 66 Stat. 479; and Pub. L. 90-433, 82 Stat. 448 (1968).

[22]For the form of notice, including the regulations under sec. 203(b)(5), as amended (49 C.F.R. 1047.20 to 1047.23 inclusive), and the proceeding leading to their adoption, see Ex Parte No. MC-75, *Implementation of Public Law 90-433—Agricultural Cooperative Transportation Exemption*, 108 M.C.C. 799 (1969).

were met.[23] On the other hand, for example, where a cooperative's trucks were dispatched with westbound loads of munitions, absent the purpose of picking up specific loads of products of members of the association on the west coast, and where, after delivery of the munitions, the vehicles were several hundred miles away from members they were to serve, the conditions of section 203(b)(5) were not satisfied.[24]

Although under section 203(b)(5), a cooperative association as defined in the Agricultural Marketing Act of 1929, as amended, may be relieved of the necessity for obtaining a certificate of public convenience and necessity,[25] other provisions relative to qualifications and maximum hours of service of employees and safety of operation and equipment are applicable to cooperatives operating motor vehicles in interstate or foreign commerce as these terms are defined in sections 203(a)(10) and (11), respectively, of the Interstate

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[23] *Northwest Agricultural Coop. Association* v. *Interstate Commerce Commission,* 350 F.2d 252 (9th Cir. 1965), *certiorari denied,* 382 U.S. 1011 (1966). It has been held that an agricultural cooperative performing transportation exempt under section 203(b)(5) is not precluded from seeking certification and obtaining a motor common carrier certificate from the Interstate Commerce Commission and that for-hire operations pursuant to such certificate would not be subject to the 15 percent nonmember limitations of section 203(b)(5). *Bray Lines, Inc.* v. *United States,* 353 F. Supp. 1240 (W.D. Okla. 1973), *judgment affirmed* by U.S. Supreme Court Oct. 9, 1973, 414 U.S. 802 (1973). The contention that the language of section 203(b)(5), properly construed, required the United States to be treated as a nonmember farmer, with the result that up to one-half of the tonnage of freight a cooperative hauls may consist of nonexempt commodities for the U.S. Government failed in *I.C.C.* v. *Big Sky Farmers & Ranchers Marketing Cooperative of Montana,* 451 F. 2d 511 (9th Cir. 1971).

[24] *Munitions Carriers Conference, Inc.* v. *American Farm Lines,* 440 F. 2d 944 (10th Cir. 1971), *affirming* 303 F. Supp. 1078 (W.D. Okla. 1969).

[25] See *Interstate Commerce Commission* v. *Jamestown Farmers Union Federated Co-op Transp. Association,* 151 F.2d 403 (8th Cir. 1945), *affirming* 57 F. Supp. 749 (D. Minn. 1944). *Cf. United States* v. *Pacific Coast Wholesalers' Association,* 338 U.S. 689 (1950). See also Camp, *Transportation Cases of Interest to Farmer Cooperatives,* FCS Service Report 62, Farmer Cooperative Service, U.S. Dept. Agr. (1963); *Agricultural Transp. Ass'n of Texas* v. *United States,* 274 F. Supp. 528 (N.D. Tex. 1967); *Interstate Commerce Commission* v. *All American Association,* 281 F. Supp. 18 (N.D. Tex. 1968); *Interstate Commerce Commission* v. *Milk Producers Marketing Company,* 405 F.2d 639 (10th Cir. 1969).

Commerce Act. However, all functions, powers, and duties of the Interstate Commerce Commission and the Chairman, members, officers and offices thereof under subsections (a)(3), (a)(3a), and (a)(5) of 49 U.S.C. 304, and, to the extent that they relate to qualifications and maximum hours of service of employees and safety of operation and equipment under subsections (a)(1) and (a)(2) of 49 U.S.C. 304, were transferred to the Secretary of Transportation by Public Law 89-670, October 15, 1966,[26] which created the U.S. Department of Transportation. Responsibility for enforcement of the motor carrier safety regulations lies with the Federal Highway Administration, Bureau of Motor Carrier Safety of the U.S. Department of Transportation.

As far as qualifications of drivers are concerned, drivers of motor vehicles controlled and operated by persons engaged in custom-harvesting operations, or by a beekeeper engaged in the seasonal transportation of bees are exempt, and an exemption under certain circumstances also exists for farm vehicle drivers as defined in the motor carrier safety regulations.[27] In general, no such exemption is available for vehicles operated and controlled by a cooperative association.

Any cooperative, before it engages in motor carrier operations, should ascertain its status with respect to the Federal Motor Carrier Act and to like applicable State statutes. An organization should not assume that it is exempt, because the assumption may prove incorrect. Again, even if it is found that the Federal Motor Carrier Act does not apply to motor vehicles controlled and operated by a cooperative as defined in the Agricultural Marketing Act of 1929, as amended, an association should ascertain and carefully observe the rules and regulations which the Department of Transportation has adopted to "permit safety of operation" and any conditions which it may have prescribed relative to "qualifications and maximum hours of service of employees and standards of equipment." Correspondence regarding the motor carrier safety regulations[28] and requests for copies of the regulations may be addressed to

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[26] 80 Stat. 931, 939-40.

[27] See 49 C.F.R. 391.2(c), (d), (e); 391.3(d); and 391.67.

[28] 49 C.F.R. Part 391.

the Department of Transportation, Bureau of Motor Carrier Safety, Washington, D.C., or one of its branch offices.

Since the Civil Aeronautics Act[29] contained no exemption similar to that in the Motor Carrier Act, it was held that a flower growers' shipping cooperative was engaged in air transportation and subject to the regulations of the Civil Aeronautics Board.[30]

A fair trade act of Wisconsin, which permitted the manufacturers of trademarked goods to enter into contracts specifying what the resale price of such products would be, contained a provision specifying that the act "shall not apply to any cooperative society or association not organized for profit," and this exception was held to be unconstitutional, although the statute was otherwise held constitutional. The court said:

> That exemption is not confined to merely transactions between such an association or society and its members. It is equally applicable to sales made by such associations or societies in competition with other retail dealers to the public at large, but as to which such exempted associations or societies would be permitted to sell at less than minimum resale prices stipulated under the Fair Trade Act. Thus there would be defeated its "primary aim to protect the property,—namely, the good will,—of the producer."[31]

It should be noted that if the exception had been upheld it would have barred cooperatives from obtaining the advantage of the statute in connection with the sale of their trademarked goods.

In holding the Growers Cost Guarantee Law of Florida relative to citrus fruit unconstitutional, the court said:

> The testimony also showed that many of the growers had organized cooperative corporations to process their

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[29]52 Stat. 973, 49 U.S.C. 401 *et seq.* See now Federal Aviation Act of 1958, 49 U.S.C. 1301 *et seq.*

[30]*Consolidated Flower Shipments, Inc.—Bay Area* v. *Civil Aeronautics Board,* 213 F. 2d 814 (9th Cir. 1954). For current CAB regulations as to cooperative shippers' associations, granting partial exemption from the provisions of the Civil Aeronautics Act, see 14 C.F.R. 296.

[31]*Weco Products Company* v. *Reed Drug Company,* 225 Wis. 474, 274 N.W. 426, 433 (1937).

grape fruit. The cooperatives did not pay cash for their fruit to these growers, but credited them with the amount of the price of the fruit and were not expected to pay for it unless the market prices enabled them to pay it, and the Commissioner did not enforce payment while requiring payment of the regular canners.

This certainly was discrimination against the canners, and the Commissioner must have construed the Act so as to authorize him to do this.[32]

A Texas statute authorized the Commissioner of Agriculture of the State to limit or provide methods for limiting the amount of citrus fruit which might be marketed in intrastate commerce, but it was held that this did not authorize him to fix minimum prices for citrus fruit.[33]

A State has the inherent power to enact legislation to promote the public welfare, and associations handling agricultural products are frequently called upon to comply with various health regulations. This power has been extended to comprehend various control programs on the part of the Federal and State governments in connection with agricultural products. In California, it has been held that an agricultural pro rate statute was constitutional.[34]

Federal Statutes Mentioning Cooperatives

This section refers briefly to a number of Federal statutes that specifically mention cooperatives. For convenience, the material will be presented under topical headings.

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[32] *Lakeland Highlands Canning Co., Inc.* v. *Mayo*, 28 F. Supp. 44, 47 (S.D. Fla. 1939).

[33] *McDonald* v. *American Fruit Growers*, 126 S.W.2d 83 (Tex. Civ. App. 1939), *appeal dismissed*, 127 S.W.2d 291 (1939). See also *Van Winkle* v. *Fred Meyer, Inc.*, 151 Ore. 455, 49 P.2d 1140 (1935).

[34] *Agricultural Prorate Commission* v. *Superior Court*, 5 Cal. 2d 550, 55 P.2d 495 (1936).

Tax Statutes

The first Federal statute[1] to mention farmer cooperatives appears to be the War Revenue Act of 1898,[2] which had a section providing for stamp taxes. It contained the following exception:

> Provided further, that the provisions of this section shall not apply to any fraternal, beneficiary society, or order, or farmers' purely local cooperative company or association, or employees' relief associations operated on the lodge system, or local cooperation plan, organized and conducted solely by the members thereof for the exclusive benefit of its members and not for profit.

Agricultural organizations were also mentioned in the Corporation Tax Statute of 1909.[3] Section 38 of that statute—which placed a tax on corporations, joint stock companies, or associations—had a proviso stating:

> *** that nothing in this section contained shall apply to labor, agricultural or horticultural organizations, or to fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders, or associations, and dependents of such members, nor to domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members ***.

The Supreme Court, in discussing the constitutionality of the Corporation Tax Statute, said:

> As to the objections that certain organizations, labor, agricultural and horticultural, fraternal and benevolent

[1] In enacting the Sherman Antitrust Act in 1890, Congress rejected an amendment to exempt agricultural associations. See "Antitrust Laws," p. 275.

[2] 30 Stat. 448, 461.

[3] 36 Stat. 11, 113.

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societies, loan and building associations, and those for religious, charitable or educational purposes, are excepted from the operation of the law, we find nothing in them to invalidate the tax. As we have had frequent occasion to say, the decisions of this court from an early date to the present time have emphasized the right of Congress to select the objects of excise taxation, and within this power to tax some and leave others untaxed, must be included the right to make exemptions such as are found in this act.[4]

Section G(a) of the Income Tax Statute of 1913[5] contained the following proviso:

> *Provided, however,* That nothing in this section shall apply to labor, agricultural, or horticultural organizations, or to mutual savings banks not having a capital stock represented by shares.

In discussing these exemptions, the Supreme Court said:[6]

> The statute provides that the tax should not apply to enumerated organizations or corporations, such as labor, agricultural or horticultural organizations, mutual savings banks, etc., and the argument is that as the amendment authorized a tax on incomes "from whatever source derived," by implication it excluded the power to make these exemptions. But this is only a form of expressing the erroneous contention as to the meaning of the amendment, which we have already disposed of. And so far as this alleged illegality is based on other provisions of the Constitution, the contention is also not open, since it was expressly considered and disposed of in *Flint* v. *Stone Tracy Co.*

Subsequent provisions of the income tax statutes of the United States as they pertain to farmer cooperatives are discussed in the section on Federal Income Taxes at page 358.

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[4] *Flint* v. *Stone Tracy Co.*, 220 U.S. 107, 173 (1911).

[5] 38 Stat. 114, 172.

[6] *Brushaber* v. *Union Pacific Railroad Co.*, 240 U.S. 1 (1916).

In 1926, the following provision was added to the statute under which dealers in leaf tobacco were required to register and render various reports and accounts to the Collector of Internal Revenue of their districts regarding the sale of leaf tobacco:

> * * * a farmer or grower of tobacco or a tobacco growers' cooperative association shall not be regarded as a dealer in leaf tobacco in respect to the leaf tobacco produced by him or handled by such association: *Provided,* That such cooperative associations shall be required to keep available records of all purchases and sales of tobacco, such records to be open to inspection by the agents of the Government. As used in this section the term "tobacco growers' cooperative association" means an association of farmers or growers of tobacco organized and operated as sales agent for the purpose of marketing the tobacco produced by its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity and quality of tobacco furnished by them.[7]

The Excise Tax Reduction Act of 1965,[8] effective January 1, 1966, repealed all provisions imposing tax on tobacco other than cigars and cigarettes and eliminating all restrictions on handling or sale of leaf tobacco or other tobacco materials.

Statutes Providing Credit Facilities

The War Finance Corporation Act was enacted in 1918.[9] In an amendment of 1921,[10] there was the following reference to cooperatives:

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[7]44 Stat. 91, 26 U.S.C. 2050(b)—the 1939 Internal Revenue Code. For subsequent statutes and historical note see 55 Stat. 225 and sec. 5702 of the Internal Revenue Code of 1954; 26 U.S.C.A. 5702.

[8]Pub. L. 89-44, 79 Stat. 136, 150.

[9]40 Stat. 506. For history see note to 15 U.S.C.A. 331-374. The corporation was abolished in 1929 and liquidated by the Secretary of the Treasury, 45 Stat. 1442.

[10]42 Stat. 181, 182.

Sec. 24. Whenever in the opinion of the Board of Directors of the Corporation the public interest may require it, the Corporation shall be authorized and empowered to make advances upon such terms not inconsistent with this Act as it may determine to any bank, banker, or trust company in the United States or to any cooperative association of producers in the United States which may have made advances for agricultural purposes including the breeding, raising, fattening, and marketing of livestock, or may have discounted or rediscounted notes, drafts, bills of exchange or other negotiable instruments issued for such purposes. Such advance or advances may be made upon promissory note or notes, or other instrument or instruments, in such form as to impose on the borrowing bank, banker, trust company, or cooperative association a primary and unconditional obligation to repay the advance at maturity with interest as stipulated therein, and shall be fully and adequately secured in each instance by indorsement, guaranty, pledge, or otherwise. Such advances may be made for a period not exceeding one year and the Corporation may from time to time extend the time of payment of any such advance through renewals, substitution of new obligations or otherwise, but the time for the payment of any such advance shall not be extended beyond three years from the date upon which such advance was originally made. The aggregate of advances made to any bank, banker, trust company, or cooperative association shall not exceed the amount remaining unpaid of the advances made by such bank, banker, trust company, or cooperative association for purposes herein described.

The Federal Reserve Act.[11] as originally enacted in 1913, in section 13 authorized any Federal reserve bank, subject to certain conditions, to discount "notes, drafts, and bills of exchange issued or drawn for agricultural * * * purposes."

In 1923[12] the provisions with reference to agricultural paper were amended, and there was added a further amendment (sec. 13a) which provided that:

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[11]38 Stat. 251, 12 U.S.C. 221 *et seq.*

[12]42 Stat. 1479, 1480, 12 U.S.C. 351.

> Notes, drafts, bills of exchange, or acceptances issued or drawn by cooperative marketing associations composed of producers of agricultural products shall be deemed to have been issued or drawn for an agricultural purpose, within the meaning of sections 348 and 349 to 352 of this title if the proceeds thereof have been or are to be advanced by such association to any members thereof for an agricultural purpose, or have been or are to be used by such association in making payments to any members thereof on account of agricultural products delivered by such members to the association, or if such proceeds have been or are to be used by such association to meet expenditures incurred or to be incurred by the association in connection with the grading, processing, packing, preparation for market, or marketing of any agricultural product handled by such association for any of its members: *Provided,* That the express enumeration in this section of certain classes of paper of cooperative marketing associations as eligible for rediscount shall not be construed as rendering ineligible any other class of paper of such associations which is now eligible for rediscount.

Congress also enacted in 1923 a statute providing for the incorporation of 12 institutions to be known as the "Federal Intermediate Credit Banks."[13] These banks were authorized to make loans, subject to certain conditions and restrictions, on staple agricultural products and on livestock, to cooperatives.

The Agricultural Marketing Act was passed in 1929. It created the Federal Farm Board and authorized that board to make loans to associations of farmers. It includes this provision:

> It is declared to be the policy of Congress to promote the effective merchandising of agricultural commodities in interstate and foreign commerce so that the industry of agriculture will be placed on a basis of economic equality with other industries, and to that end to protect, control, and stabilize the currents of interstate

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[13]42 Stat. 1454, 12 U.S.C. 1021. See now Farm Credit Act of 1971, 12 U.S.C. 2001 *et seq.*

and foreign commerce in the marketing of agricultural commodities and their food products * * *.

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(3) by encouraging the organization of producers into effective associations or corporations under their own control for greater unity of effort in marketing and by promoting the establishment and financing of a farm marketing system of producer-owned and producer-controlled cooperative associations and other agencies.[14]

The Act also authorized the Federal Farm Board to encourage "the organization, improvement in methods, and development of effective cooperative associations."

The Farm Credit Act of 1933[15] authorized the organization of 12 regional banks for cooperatives and the Central Bank for Cooperatives, for the purpose of making loans to cooperatives meeting the definition of such associations, as contained in section 15(a) of the Agricultural Marketing Act, as amended. The definition[16] reads as follows:

As used in this subchapter, the term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services: *Provided, however,* That such associations are operated for the mutual benefit of the members thereof as such producers or purchasers and conform to one or both of the following requirements:

First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

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[14]46 Stat. 11, 12 U.S.C. 1141(a).

[15]48 Stat. 257, 261, 12 U.S.C. 1134, 1134(f). See now Farm Credit Act of 1971, 12 U.S.C. 2001 *et seq.*

[16]49 Stat. 317, 12 U.S.C. 1141(j)(a).

Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

And in any case to the following:

Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.

The Farm Credit Act of 1933 and other Acts relating to the Farm Credit System were repealed and replaced by the Farm Credit Act of 1971.[17] No change was made in the Agricultural Marketing Act.[18] Title III of the 1971 Act broadens and clarifies the functions and powers of the banks for cooperatives. An independent definition of eligibility of cooperatives to borrow from the banks for cooperatives is contained in section 3.8 (12 U.S.C. 2129) and reads as follows:

Sec. 3.8. Eligibility.—Any association of farmers, producers, or harvesters of aquatic products, or any federation of such associations, which is operated on a cooperative basis, and has the powers for processing, preparing for market, handling, or marketing farm or aquatic products; or for purchasing, testing, grading, processing, distributing, or furnishing farm or aquatic supplies or furnishing farm business services or services to eligible cooperatives and conforms to either of the two following requirements:

(a) no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; or

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[17]85 Stat. 583, 12 U.S.C. 2001.

[18]See definition of "cooperative association" in the text at footnote 16 in this section.

(b) does not pay dividends on stock or membership capital in excess of such per centum per annum as may be approved under regulations of the Farm Credit Administration; and in any case

(c) does not deal in farm products or aquatic products, or products processed therefrom, farm or aquatic supplies, or farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members, excluding from the total of member and nonmember business transactions with the United States or any agency or instrumentality thereof or services or supplies furnished as a public utility; and

(d) a percentage of the voting control of the association not less than 80 per centum, or such higher percentage as established by the district board is held by farmers, producers or harvesters of aquatic products, or eligible cooperative associations as defined herein;

shall be eligible to borrow from a bank for cooperatives.

Other significant changes provide more latitude in determining the amount of stock in the banks for cooperatives which a borrower must acquire and a broader authority for the distribution of patronage refunds.

The new eligibility definition includes associations of producers or harvesters of aquatic products as well as associations of farmers among the cooperatives that may borrow. It permits the district Farm Credit boards to prescribe the percentage of voting control in the cooperative which must be held by farmers or by producers or harvesters of aquatic products or eligible cooperative associations to not less than 80 percent. It retains the eligibility requirement that the association does not deal with nonmembers in a greater amount in value than the total amount of business transacted by it with or for members. Excluded from this 50 percent rule is business done by the cooperative in furnishing services or

supplies as a public utility as well as business transactions with the United States or any agency thereof.

These changes of course do not affect the organization of cooperatives. They still must comply with applicable State laws and their charter or bylaw provisions with respect to the producer status of their members. The new law will make financing through the banks for cooperatives available to some purchasing and supply and business service cooperatives which may accept some nonproducers as members, or that may be able to restrict voting control to producers.

The Rural Electrification Act of 1936, as amended,[19] contains the following reference to cooperatives:

> The Administrator is authorized and empowered, from the sums hereinbefore authorized, to make loans for rural electrification to persons, corporations, States, Territories, and subdivisions and agencies thereof, municipalities, peoples' utility districts and cooperative, nonprofit, or limited-dividend associations, organized under the laws of any State or Territory of the United States, for the purpose of financing the construction and operation of generating plants, electric transmission and distribution lines or systems for the furnishing of electric energy to persons in rural areas who are not receiving central station service *** *Provided,* That the Administrator, in making such loans, shall give preference to States, Territories, and subdivisions and agencies thereof, municipalities, peoples' utility districts, and cooperative, nonprofit, or limited-dividend associations, the projects of which comply with the requirements of this chapter. ***

This Act was amended in 1949[20] to provide for loans for rural telephone service. Under section 201 of the Act:

> *** the Administrator is authorized and empowered to make loans to persons now providing or who may hereafter provide telephone service in rural areas and to

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[19]49 Stat. 1363, 1365; 7 U.S.C. 904.

[20]63 Stat. 948, 7 U.S.C. 922.

cooperative, nonprofit, limited dividend, or mutual associations *** *Provided, however,* That the Administrator, in making such loans, shall give preference to persons providing telephone service in rural areas, and to cooperative, nonprofit, limited dividend, or mutual associations ***.

The Act was further amended in 1971 to establish a Government corporation known as the Rural Telephone Bank, an agency and instrumentality of the United States.[21] Equity capital will be furnished by the United States, borrowers and those eligible to borrow, and their organizations. When, after June 30, 1985, 51 percent of the Government furnished capital has been retired, the bank will cease to be an agency of the United States, but will continue as an instrumentality of the Government.

Telephone Bank loans are limited to entities which have received a loan or loan commitment pursuant to section 201 of the Act or which have been certified by the Administrator to be eligible for such a loan or loan commitment.[22] The statute requires the board of directors of the Rural Telephone Bank to be composed of three directors from "cooperative-type entities" and three directors from "commerical-type entities" in addition to directors representing the Government and the general public.

The Rural Telephone Bank provides an additional source of financing for cooperative and other telephone organizations capable of paying more than the statutory interest rates established for loans from the Rural Electrification Administration. It will expand credit resources by obtaining a supply of funds through the sale of stock and debentures.[23]

Legislative efforts to establish a similar bank for electric cooperatives had earlier been unsuccessful. Electric cooperatives formed their own organization in 1969, the National Rural

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[21]85 Stat. 29, 7 U.S.C. 931, 941. The Bank as an agency of the United States is not an entity subject to Federal income tax. Internal Revenue Service ruling to U.S. Dept. of Agr., Office of the General Counsel, Feb. 3, 1972.

[22]7 U.S.C. 948(a) as amended by Pub. L. 93-32, approved May 11, 1973, 87 Stat. 70, 71.

[23]Weitzell, *The Rural Telephone Bank—New Financing for Rural Telephony,* Public Utilities Fortnightly, Oct. 28, 1971. See Pub. L. 92-324, approved June 30, 1972.

Utilities Cooperative Finance Corporation (CFC) under the District of Columbia Cooperative Associations Act,[24] to provide member cooperatives with loan capital supplementing that available from REA.

The Department of Agriculture announced by press release on Dec. 29, 1972, that effective Jan. 1, 1973, the program of 2 percent direct loans administered by the Rural Electrification Administration under the RE Act was being changed to a program of insured and guaranteed loans at higher interest rates under the Rural Development Act of 1972 (Pub. L. 92-419, 86 Stat. 657). The release stated that "This change is a part of the effort to hold 1973 federal budget outlays to $250 billion and keep the outstanding public debt within the statutory limit of $465 billion through June 30, 1973. It will eliminate direct federal loans and substitute credit from private sources at interest rates that are more in line with the cost of money on today's market. Insured and guaranteed loans will reduce the impact on the federal budget and the public debt and are designed to facilitate more rapid growth in the credit programs being provided by the National Rural Utilities Cooperative Finance Corporation, the Rural Telephone Bank, and other private lenders." The release further indicated that loans to electric cooperatives would be made on an insured basis under the Rural Development Act of 1972 at a 5-percent interest rate and that guaranteed loans would be available to cooperatives "where private capital is available on advantageous terms." Congress undertook further amendment of the RE Act.[25]

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[24]54 Stat. 480; District of Columbia Code Encyclopedia (1968 Ed.), §29-801 *et seq.* In this connection, Pub. L. 91-385 (1970) amended the Cooperative Associations Act (§ 29-843) so that associations formed under the Act for the purpose of providing financing for their members and the members of such associations engaged in utility operations would be exempt from the District of Columbia laws relating to licenses for loaning of money and interest rates.

[25]See statement of Secretary of Agriculture, Earl L. Butz, before the Senate Committee on Agriculture and Forestry, Feb. 1, 1973; Sawicki, *Rural Electrics Go to Wall Street,* The Washington Post, Feb. 18, 1973 (Outlook), at B5; S. Rep. 93-20, 93rd Cong., 1st sess. (Feb. 15, 1973), Restoration of Rural Electric and Telephone Direct Loan Programs; H.R. Rep. 93-91, 93rd Cong., 1st sess. (Mar. 27, 1973), Rural Electrification Act, Report together with Supplemental Views to accompany H.R. 5683; H.R.Rep. No. 93-169, 93rd Cong., 1st sess. (May 9, 1973), Rural Electric and Telephone Loans, Conference Report.

It was held in *Sioux Valley Empire Electric Association, Inc.* v. *Butz,* 367 F. Supp. 686 (D.S.Dak. 1973), that the plaintiff's loan application which was pending at the time of the Dec. 29, 1972 press release should be considered on the basis of RE Act provisions and regulations in effect prior to the press release. The decision is being appealed.

On May 11, 1973, the RE Act was again amended when the President signed Public Law 93-32.[26] This amendment establishes a revolving fund for the making of insurable loans at statutory interest rates of 2 or 5 percent. The 2-percent rate is available only to borrowers with an average consumer or subscriber density of two or fewer per mile, or with an average gross revenue per mile of at least $450 below the average gross revenue per mile (for electric borrowers) or $300 below the average gross revenue per mile (for telephone borrowers), or to those borrowers which are determined by the Administrator of REA, in his sole discretion, to need the 2-percent interest rate because of extenuating circumstances, extreme hardship, or other conditions. Others will be eligible to borrow at the 5-percent interest rate. The amendment also authorizes REA to guarantee loans obtained from other sources at interest rates agreed upon between the borrower and the lender.

Antitrust and Related Statutes

The Clayton Act[27] was enacted in 1914. Section 6 of that Act purported to give agricultural associations which met certain conditions immunity under the antitrust laws.[28]

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[26]87 Stat. 65. See *1973 Rural Electrification Act Amendments, P.L. 93-32,* a talk by R. Stanley Harsh, Assistant General Counsel, U.S. Dept. Agriculture, REA Field Conference, Denver, Colo., June 27, 1973, and *The Meaning of the New REA Legislation—For Borrowers and Government,* by Louis Gorrin in 31 Rural Electrification 21 (No. 10, July 1973).

See also talk by Normam L. Plotka entitled *Legal Aspects of REA Guaranteed Loan Program,* NRECA Annual Meeting, San Francisco, Calif., Feb. 11, 1974. The Federal Financing Bank, created by the Federal Financing Bank Act of 1973, Pub. L. 93-224, is expected to participate in the new REA guaranteed loan programs. It will also consolidate the financing of a variety of Federal agencies and other borrowers whose obligations are guaranteed by the Federal Government. See statement of Edward M. Roob, Special Assistant to the Secretary of the Treasury, before the 1974 Bank Investments Conference of the American Bankers Association, New Orleans, La., Feb. 19, 1974.

[27]38 Stat. 730, 15 U.S.C. 12.

[28]See p. 290 for a discussion of sec. 6 of the Clayton Act.

The appropriations acts for the Department of Justice beginning with the fiscal year ending June 30, 1914,[29] and up to and including the appropriation for the fiscal year ending June 30, 1928,[30] contained the following provision relative to cooperatives:

> Enforcement of antitrust laws. For the enforcement of antitrust laws * * * *provided further,* that no part of this appropriation shall be expended for the prosecution of producers of farm products and associations of farmers who cooperate and organize in an effort to and for the purpose to obtain and maintain a fair and reasonable price for their products.

The Capper-Volstead Act became a law in 1922.[31] The object of this law was to permit associations of farmers, corporate or otherwise, and formed with or without capital stock, that met the conditions prescribed in the Act, to organize and operate in a normal manner without thereby subjecting themselves to liability under the antitrust statutes as combinations in restraint of trade.[32]

The Robinson-Patman Act,[33] enacted in 1936, relating to price discrimination between purchasers, provides in section 4 that:

> Nothing in sections 13 to 13b and 21a of this title shall prevent a cooperative association from returning to its members, producers, or consumers the whole, or any part of, the net earnings or surplus resulting from its trading operations, in proportion to their purchases or sales from, to, or through the association.

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[29]38 Stat. 53.

[30]44 Stat. 1194.

[31]42 Stat. 388, 7 U.S.C. 291.

[32]For the first Supreme Court case construing the Capper-Volstead Act, see *United States* v. *Borden Company,* 308 U.S. 188 (1939), *reversing* 28 F. Supp. 177 (N.D. Ill. 1939). See also discussion of the "Capper-Volstead Act." at p. 293.

[33]49 Stat. 1526, 1528, 15 U.S.C. 13, 13b.

Section 26 of a statute enacted in 1917 entitled, "An act to provide further for the national security and defense by encouraging the production, conserving the supply, and controlling the distribution of food products and fuel" prohibited the hoarding of food and contained provisos reading as follows:

> *Provided,* That any storing or holding by any farmer, gardener, or other person of the products of any farm, garden, or other land cultivated by him shall not be deemed to be a storing or holding within the meaning of this Act: *Provided further,* That farmers and fruit growers, cooperative and other exchanges, or societies of a similar character shall not be included within the provisions of this section.[34]

The Packers and Stockyards Act was enacted in 1921. By this Act Congress gave the Secretary of Agriculture a certain degree of regulatory authority over stockyards and those doing business therein. Section 306(f) of that Act provides that persons carrying on the business of a stockyard owner or market agency must file and publish their rates, and prohibits the making of rebates by them. In parentheses it is stated:

> (but this shall not prohibit a cooperative association of producers from bona fide returning to its members, on a patronage basis, its excess earnings on their livestock, subject to such regulations as the Secretary may prescribe) ***.[35]

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[34]40 Stat. 276, 286. This was a war measure and sec. 24 (p. 283) provided: "That the provisions of this Act shall cease to be in effect when the existing state of war between the United States and Germany shall have terminated, and the fact and date of such termination shall be ascertained and proclaimed by the President. . . ."

[35]42 Stat. 159, 164, 7 U.S.C. 181, 207(f). The Supreme Court held this Act constitutional in *Stafford* v. *Wallace,* 258 U.S. 495, 23 A.L.R. 229 (1922). See Rev. Rul. 73-59, 1973-1 Cum. Bull. 292.

The Future Trading Act, which was enacted in 1921,[36] gave the Secretary of Agriculture regulatory power over boards of trade and contained provisions with respect to the admission of cooperatives to boards of trade similar to those provided for in the Grain Futures Act,[37] which was subsequently enacted and which will be discussed later. The Future Trading Act was held unconstitutional because it involved a wrongful use of the taxing power of Congress.[38]

In 1922, the Grain Futures Act[39] based upon the interstate commerce power, was enacted. This Act conferred regulatory power on the Secretary of Agriculture with respect to boards of trade. It forbade the exclusion from any board of trade that was designated as a contract market of the duly authorized representatives of any association of producers meeting the requirements of the statute. Section 5(e) further provides:

> That no rule of a contract market shall forbid or be construed to forbid the return on a patronage basis by such cooperative association to its bona fide members of moneys collected in excess of the expense of conducting the business of such association.

In a case involving the constitutionality of this statute, the Supreme Court said:[40]

> The next provision of the act which is attacked as invalid is that which forbids a board, designated as a contract market, from excluding from membership in, and all privileges on, its exchanges any duly authorized representative of a lawfully formed and conducted association of producers having adequate financial responsibility, engaged in the cash grain business, and complying or agreeing to comply with the terms and conditions lawfully imposed on the other members, and which bars any

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[36] 42 Stat. 187.

[37] 42 Stat. 998.

[38] *Hill* v. *Wallace*, 259 U.S. 44 (1922).

[39] 42 Stat. 998, 1001.

[40] *Board of Trade of the City of Chicago* v. *Olsen*, 262 U.S. 1, 40 (1923).

rule forbidding the return by such association of the commissions of its representative, less expenses, to the *bona fide* members of the cooperative association in proportion to their consignments of grain to the exchange. It is said that this will impair the value of membership in the Board and will take the property of the members without due process of law.

The Board of Trade conducts a business which is affected with a public interest and is, therefore, subject to reasonable regulation in the public interest. * * * The incidental effect which such reasonable rules may have, if any, in lowering the value of memberships does not constitute a taking, but is only a reasonable regulation in the exercise of the police power of the National Government. Congress evidently deems it helpful in the preservation of the vital function which such a board of trade exercises in interstate commerce in grain that producers and shippers should be given an opportunity to take part in the transactions in this world market through a chosen representative. Nor do we see why the requirement that the relation between them and this representative, looking to economy of participation on their part by a return of patronage dividends, should not be permissible because facilitating closer participation by the great body of producers in transactions of the Board which are of vital importance to them.

The Grain Futures Act was amended in 1936 and the title was changed to the Commodity Exchange Act.[41] In the later Act, the original provisions concerning the admission of the duly authorized representatives of cooperatives to boards of trade were expanded and strengthened.

In 1927 Congress enacted a statute[42] forbidding, subject to certain conditions, boards of trade and exchanges on which agricultural products were bought and sold from excluding the duly authorized representative of any lawfully formed and conducted cooperative "composed substantially of producers of agricultural products." This statute contains a provision

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[41] 49 Stat. 1491, 7 U.S.C. 1.

[42] 44 Stat. 1423, 15 U.S.C. 431.

identical to the provision heretofore quoted from the Grain Futures Act, providing that no rule of a board of trade should be construed to prevent the paying of patronage refunds by an association of producers.

Section 3(a) of the Securities Act of 1933 deals with exempted securities, and paragraph (5) of that section reads:

> Any security issued (A) by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution, except that the foregoing exemption shall not apply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 per centum of the face value of such security; or (B) by (i) a farmer's cooperative organization exempt from tax under section 521 of Title 26, (ii) a corporation described in section 501(c)(16) of Title 26 and exempt from tax under section 501(a) of Title 26, or (iii) a corporation described in section 501(c)(2) of Title 26 which is exempt from tax under section 501(a) of Title 26 and is organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization or corporation described in clause (i) or (ii).[43]

Section 12(g) of the Securities Exchange Act of 1934, as amended, contains the following exemption for securities of cooperative organizations.

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[43]48 Stat. 74, 15 U.S.C. 77c(5). For a discussion of the scope and nature of this exemption and the exemption under the Securities Exchange Act of 1934, as amended in 1964, see Weiss, *So You Think You're Exempt From The Federal Securities Laws*, Cooperative Accountant, Spring 1973, 2; Weiss, *Security Regulations Can Affect Cooperative Growth*, American Cooperation—1972-73, 285.

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The provisions of this subsection shall not apply in respect of—

* * * * * * *

(E) any security of an issuer which is a "cooperative association" as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended, or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined.

(F) any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit, but only if the security is part of a class issuable only to persons who purchase commodities or services from the issuer, the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security.[44]

As to requirements under the Motor Carrier Act, 1935, as amended, see page 515.

The Bituminous Coal Conservation Act of 1935[45] contained the following language:

It shall not be an unfair method of competition or a violation of the code or any requirement of this Act (1) to sell to or through any bona fide and legitimate farmer's cooperative organization duly organized under the laws of any State, Territory, the District of Columbia, or the United States whether or not such organization grants rebates, discounts, patronage dividends, or other similar benefits to its members, (2) to sell through any intervening agency to any such cooperative organization, or (3) to pay or allow to any such cooperative organization or to any such intervening agency any discount, commission, rebate, or dividend ordinarily paid or allowed, or per-

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[44]48 Stat. 892; Pub. L. 88-467, 78 Stat. 565-568 (1964); 15 U.S.C. 78*l*(g)(2)(E) and (F).

[45]49 Stat. 991, 1000; 15 U.S.C. 801.

mitted by the code to be paid or allowed, to other purchasers for purchases in wholesale or middleman quantities.

The Act was subsequently held unconstitutional[46] and was repealed by the Bituminous Coal Act of 1937,[47] which, however, reenacted the quoted language.[48] The phrase "bona fide and legitimate farmer's cooperative," as used in the Act, was held not to include a regional cooperative which had consumer cooperatives among its membership.[49]

While the Agricultural Marketing Agreement Act of 1937 might properly be discussed here, as it is so closely related to the Agricultural Adjustment Act, it is treated under the next topical heading.

Agricultural Adjustment and Soil Conservation Statutes

The original Agricultural Adjustment Act was enacted in 1933.[50] Section 8 of that Act contained the following provisions:

> In order to effectuate the declared policy, the Secretary of Agriculture shall have power * * *
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> (2) To enter into marketing agreements with processors, associations of producers, and others engaged in the handling, in the current of interstate or foreign commerce of any agricultural commodity or product thereof, after due notice and opportunity for hearing to interested parties. The making of any such agreement shall not be held to be in violation of any of the antitrust laws of the United States, and any such agreement shall be deemed to be lawful: *Provided,* That no such agreement shall remain in force after the termination of this Act. For the purpose of carrying out any such agreement the parties

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[46] *Carter* v. *Carter Coal Co.*, 298 U.S. 238 (1936).

[47] 50 Stat. 90, 15 U.S.C. 850.

[48] 50 Stat. 72, 15 U.S.C. 833. The Bituminous Coal Act of 1937 was repealed in 1966. Pub. L. 89-554, §8(a), 80 Stat. 649, 651.

[49] *Midland Cooperative Wholesale* v. *Ickes*, 125 F. 2d 618 (8th Cir. 1942).

[50] 48 Stat. 31. The Agricultural Adjustment Act is contained in 7 U.S.C. 601 to 659, inclusive.

thereto shall be eligible for loans from the Reconstruction Finance Corporation under section 5 of the Reconstruction Finance Corporation Act. Such loans shall not be in excess of such amounts as may be authorized by the agreements.

(3) To issue licenses permitting processors, associations of producers, and others to engage in the handling, in the current of interstate or foreign commerce, of any agricultural commodity or product thereof, or any competing commodity or product thereof. Such licenses shall be subject to such terms and conditions, not in conflict with existing Acts of Congress or regulations pursuant thereto, as may be necessary to eliminate unfair practices or charges that prevent or tend to prevent the effectuation of the declared policy and the restoration of normal economic conditions in the marketing of such commodities or products and the financing thereof. The Secretary of Agriculture may suspend or revoke any such license, after due notice and opportunity for hearing, for violations of the terms or conditions thereof. Any order of the Secretary suspending or revoking any such license shall be final if in accordance with law. Any such person engaged in such handling without a license as required by the Secretary under this section shall be subject to a fine of not more than $1,000 for each day during which the violation continues.

The Act, as amended, contains several other references to cooperatives, among which is section 610(b)(1), 7 U.S.C.:

The Secretary of Agriculture is authorized to establish, for the more effective administration of the functions vested in him by this chapter, State and local committees, or associations of producers, and to permit cooperative associations of producers, when in his judgment they are qualified to do so, to act as agents of their members and patrons in connection with the distribution of payments authorized to be made under section 608 of this title. The Secretary, in the administration of this chapter, shall accord such recognition and encouragement to producer-owned and producer-controlled cooperative associations as will be in harmony with the pol-

> icy toward cooperative associations set forth in existing acts of Congress, and as will tend to promote efficient methods of marketing and distribution.

These and other sections of the Agricultural Adjustment Act were amended in 1935.[51] Following an adverse decision by the Supreme Court of the United States[52] in a case involving the payment of processing taxes under the Agricultural Adjustment Act, the sections of the original Act, as amended which dealt with matters other than processing taxes were reenacted in the Agricultural Marketing Agreement Act of 1937.[53]

The following provision which appeared in the Agricultural Adjustment Act, as amended, was adopted by the Agricultural Marketing Agreement Act:

> The Secretary, in the administration of this chapter, shall accord such recognition and encouragement to producer-owned and producer-controlled cooperative associations as will be in harmony with the policy toward cooperative associations set forth in existing acts of Congress, and as will tend to promote efficient methods of marketing and distribution.[54]

This language was before the United States Supreme Court in *United States* v. *Rock Royal Cooperative, Inc.*,[55] and with regard to it, Mr. Justice Reed said:

> These agricultural cooperatives are the means by which farmers and stockmen enter into the processing and distribution of their crops and livestock. The distinctions between such cooperatives and business organizations have repeatedly been held to justify different treatment. * * *
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> * * * * *

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[51]49 Stat. 750. The licensing section, 8(3), was omitted and the other sections were amended.

[52]*United States* v. *Butler*, 297 U.S. 1, 102 A.L.R. 914 (1936).

[53]50 Stat. 246.

[54]48 Stat. 37, 49 Stat. 767, 50 Stat. 246, 7 U.S.C. 610(b)(1).

[55]307 U.S. 533, 563, 564 (1939).

The producer cooperative seeks to return to its members the largest possible portion of the dollar necessarily spent by the consumer for the product with deductions only for modest distribution costs, without profit to the membership cooperative and with limited profit to the stock cooperative. It is organized by producers for their mutual benefit. For that reason, it may be assumed that it will seek to distribute the largest amounts to its patrons.

The commodity handled by a cooperative corresponds for some purposes to the capital of a business corporation. Either may cut sale prices below cost, one as long as its members will deliver, the other as long as its assets permit. When proprietary corporations lower sales prices, they naturally seek to lower purchase prices. Their profit depends on spread. On the other hand, the cooperative cannot pass the reduction. All the selling price less expense is available for distribution to its patrons. As its own members bear the burden of price cutting, it was reasonable to exempt it from the payment of the fixed price. The cooperative member measures his return by the market or uniform price the business handler pays. In commodities with the wide market of stable dairy products, quotations are readily available. If distributions do not equal open prices, the cooperators' reactions would parallel those of stockholders of losing businesses. Neither the act nor the order protects anyone from lawful competition, nor is it essential that they should do so. We do not find an unreasonable discrimination in excepting producers' cooperatives from the requirement to pay a uniform price.

In many of the other agricultural statutes administered by the United States Department of Agriculture, there are references more or less significant to cooperatives.[56]

The initial Soil Erosion Act, enacted in 1935,[57] contained

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[56]Tobacco Control Act, 49 Stat. 1240, 7 U.S.C. 515d; Freight Rate Adjustments, 52 Stat. 36, 7 U.S.C. 1291(d); Crop Insurance, 52 Stat. 73, 7 U.S.C. 1507(c) and (e).

[57]49 Stat. 163, 16 U.S.C. 590.

no reference to cooperatives. This Act became the Soil Conservation and Domestic Allotment Act by virtue of an amendment made in 1936, but it was not until 1938 that specific mention of cooperatives was made by this Act. At that time, section 8(b)[58] was amended to include the following:

> In carrying out the provisions of this section, the Secretary shall, as far as practicable, protect the interests of tenants and sharecroppers; is authorized to utilize the agricultural extension service and other approved agencies; shall accord such recognition and encouragement to producer-owned and producer-controlled cooperative associations as will be in harmony with the policy toward cooperative associations set forth in existing Acts of Congress and as will tend to promote efficient methods of marketing and distribution; shall not have power to acquire any land or any right or interest therein; shall, in every practicable manner, protect the interests of small producers; and shall in every practical way encourage and provide for soil-conserving and soil-rebuilding practices rather than the growing of soil-depleting crops. ***

The Agricultural Adjustment Act of 1938[59] contains a number of references to cooperatives. In connection with the adjustment in freight rates, it is provided:

> The Secretary is authorized to cooperate with and assist cooperative associations of farmers making complaint to the Interstate Commerce Commission with respect to rates, charges, tariffs, and practices relating to the transportation of farm products.[60]

As codified the Act contains also the following provision:

> The provisions of sections 590h(b) and 590k of Title 16 [Soil Conservation], relating to the utilization of State, county, local committees, the extension service, and

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[58]52 Stat. 31, 32, 16 U.S.C. 590h(b).
[59]52 Stat. 31, 7 U.S.C. 1281 to 1407, inclusive.
[60]52 Stat. 36, 37; 7 U.S.C. 1291(d).

other approved agencies, and to recognition and encouragement of cooperative associations, shall apply in the administration of this chapter; and the Secretary shall, for such purposes, utilize the same local, county, and State committees as are utilized under sections 590g, 590h, 590i, and 590j to 590p, 590q of Title 16.[61]

The Federal Crop Insurance Act[62] enacted in 1938 contains the following statement:

> In carrying out the provisions of this chapter the Board may, in its discretion, utilize producer-owned and producer-controlled cooperative associations.[63]

Agricultural Fair Practices Act

The Agricultural Fair Practices Act of 1967[64] protects farmers' rights to organize and join cooperatives. The law establishes standards of fair practices for handlers and processors who deal with farmers. It prohibits them from discriminating against farmers because they are members of a producers' association.

Under the Act, it is unlawful for any handler[65] knowingly

- to coerce any agricultural producer in the exercise of his right to join or refrain from joining an association of producers;
- to refuse to deal with any producer because he has exercised his right to join such an association;
- to discriminate against any producer with respect to price, quantity, quality, or other terms of purchase because of his membership in such an association or his contract with it;

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[61]52 Stat. 68, 7 U.S.C. 1388(a).

[62]52 Stat. 72, 7 U.S.C. 1501 *et seq.*

[63]52 Stat. 73, 7 U.S.C. 1507(e).

[64]Pub. L. 90-288, 82 Stat. 93, 7 U.S.C. 2301-2306 (1968).

[65]A milk producers' association that engaged in activities included in those defined as that of a "handler" could be found to be a "handler" under the Act. *Marketing Assistance Plan, Inc.* v. *Associated Milk Producers, Inc.*, 338 F. Supp. 1019 (S.D. Tex. 1972).

— to coerce or intimidate any producer to enter into, maintain, breach, cancel, or terminate a membership agreement or marketing contract with an association of producers or a contract with a handler;
— to pay or loan money, give anything of value, or offer any other inducement or reward to a producer for refusing to or ceasing to belong to an association of producers;
— to conspire, combine, agree, or arrange with any other person to do or aid or abet the doing of any of these acts; or
— to make false reports about the finances, management, or activities of associations of producers or handlers.

Enforcement is through injunction upon application of the aggrieved party or the Secretary of Agriculture through the Attorney General, and through civil actions for compensatory damages by persons injured in their business or property by reason of any violation. The district courts of the United States are given jurisdiction of proceedings under the Act.[66]

Statutes Providing for Research

The Appropriation Act for the Department of Agriculture for the fiscal year beginning July 1, 1913,[67] contained the following provision:

> That the President of the United States shall appoint a commission composed of not more than seven persons who shall serve without compensation to cooperate with the American commission assembled under the auspices of the Southern Commercial Congress to investigate and study in European countries cooperative land-mortgage banks, cooperative rural credit unions, and similar organizations and institutions devoting their attention to

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[66]Congress had not preempted the field of agricultural marketing and a State court had authority to determine suit to enjoin defendants from allegedly interfering with milk marketing contracts between plaintiffs and their dairy farmer members. *Pure Milk Product Co-operative* v. *National Farmers Organization,* 332 F. Supp. 866 (E.D. Wis. 1971).

[67]37 Stat. 828, 855.

> the promotion of agriculture and the betterment of rural conditions, and for the purpose of its investigations the commission shall be authorized to incur and have paid upon the certificate of its chairman such expenses in the city of Washington and elsewhere for the payment of the salaries of employees, clerks, stenographers, assistants and such other necessary expenses as the commission may deem necessary: *Provided,* That the total expenses incurred for all purposes shall not exceed the sum of $25,000, and the said commission shall submit a report to Congress as early as practicable, embodying the results of its investigations and such recommendations as it may see fit to make.

Acting under this authorization the American and United States Commission for the study of agricultural cooperation in Europe undertook an investigation in Europe in 1913, and its results are published in a 900-page report, which has been printed as a public document.[68]

The Appropriation Act just referred to also contained the following provision:[69]

> To enable the Secretary of Agriculture to acquire and to diffuse among the people of the United States useful information on subjects connected with the marketing and distributing of farm products, and for the employment of persons and means necessary in the city of Washington and elsewhere, there is hereby appropriated the sum of $50,000, of which sum $10,000 shall be immediately available.

Pursuant to this authority, the Office of Markets[70] was organized, in which a project "Cooperative Purchasing and Marketing" was established in 1913. This project engaged in research and other work relative to agricultural cooperation which was continued by it and its successors, pursuant to

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[68] *Agricultural Cooperation and Rural Credit in Europe,* 63d Cong., 1st sess., S. Doc. 214, 3 pts. See also Elsworth, *The Story of Farmers' Cooperatives*, FCS Educ. Cir. 1, Farmer Cooperative Service, U.S. Dept. Agr. (1954), p. 14.

[69] 37 Stat. 854.

[70] Elsworth, *The Story of Farmers' Cooperatives*, FCS Educ. Cir. 1, Farmer Cooperative Service, U.S. Dept. Agr. (1954), p. 14.

authority contained in subsequent appropriation acts until the enactment of the Cooperative Marketing Act of 1926. The purposes of this Act are disclosed by its title, which reads:[71]

> An Act to create a division of cooperative marketing in the Department of Agriculture; to provide for the acquisition and dissemination of information pertaining to cooperation; to promote the knowledge of cooperative principles and practices; to provide for calling advisers to counsel with the Secretary of Agriculture on cooperative activities; to authorize cooperative associations to acquire, interpret, and disseminate crop and market information, and for other purposes.

Under this Act, the United States Department of Agriculture, through the Farmer Cooperative Service, is authorized:

1. To acquire, analyze, and disseminate economic, statistical, and historical information regarding the progress, organization, and business methods of cooperatives in the United States and foreign countries.

2. To conduct studies of the economic, legal, financial, social, and other phases of cooperation, and publish the results thereof. Such studies shall include the analyses of the organization, operation, financial, and merchandising problems of cooperatives.

3. To make surveys and analyses if deemed advisable of the accounts and business practices of representative cooperatives upon their request; to report to the cooperative so surveyed the results thereof; and with the consent of the cooperative so surveyed to publish summaries of the results of such surveys, together with similar facts, for the guidance of cooperatives and for the purpose of assisting cooperatives and developing methods of business and market analysis.

4. To confer and advise with committees or groups of producers, if deemed advisable, that may be desirous of forming a cooperative and to make an economic survey and analysis of the facts surrounding the production and marketing of the agricultural product or products which the cooperative, if formed, would handle or market.

5. To acquire from all available sources information concerning crop prospects, supply, demand, current receipts, exports, imports, and prices of the agricultural products handled or

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[71] 44 Stat. 802, 7 U.S.C. 451.

marketed by cooperatives, and to employ qualified commodity marketing specialists to summarize and analyze this information and disseminate the same among cooperatives and others.

6. To promote the knowledge of cooperative principles and practices and to cooperate, in promoting such knowledge, with educational and marketing agencies, cooperatives, and others.

7. To make such special studies, in the United States and foreign countries, and to acquire and disseminate such information and findings as may be useful in the development and practice of cooperation.

In accordance, with an Executive order in 1929[72] the Cooperative Marketing Division was transferred from the Department of Agriculture to the Federal Farm Board, and in accordance with another Executive order executed in 1933[73] the Division became a part of the Farm Credit Administration. On December 4, 1953, it was transferred from the Farm Credit Administration to the Secretary of Agriculture and established as the Farmer Cooperative Service of the United States Department of Agriculture.[74]

Statutes Involving Electric Projects

The Tennessee Valley Authority Act of 1933, as amended,[75] authorizes the board of directors of TVA to cooperate "with farmers, landowners, and associations of farmers or landowners, for the use of new forms of fertilizer or fertilizer practices ***." The Act, as amended, provides that States, counties, municipalities, and cooperative organizations of citizens or farmers shall be entitled to preference in the sale of surplus power,[76] and to facilitate the disposition of surplus power, the corporation is authorized to extend credit to such institutions for a period not exceeding 5 years.

The Acts authorizing the Bonneville project,[77] the Reclama-

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[72]Exec. Order 5200, dated and effective Oct. 1, 1929.

[73]Exec. Order 6084, dated Mar. 27, 1933, effective May 27, 1933.

[74]67 Stat. 390, 394; 7 U.S.C. 452 note; Secretary's Memorandum No. 1320, Supp. No. 4, Nov. 2, 1953.

[75]48 Stat. 58, 49 Stat. 1076; 16 U.S.C. 831d(c).

[76]16 U.S.C. 831i.

[77]16 U.S.C. 832c(a).

tion Project of 1939,[78] the Fort Peck project,[79] water storage facilities,[80] Niagara Power,[81] and Flood Control of 1944,[82] also confer on cooperatives certain preferences and priorities in the purchase of power.

Other Programs

The Department of Agriculture is also authorized to use cooperatives in its price support and commodity loan programs, and to assist rural people and their communities to improve their economic and social positions through effective self-help programs and credit.[83]

The most significant references to cooperatives are those contained in the Federal statutes cited in this section. Of course, there are other Federal statutes which affect cooperatives as they do other business entities; such, for example, as the Federal Trade Commission Act,[84] the Perishable Agricultural Commodities Act,[85] the National Labor Relations Act,[86] the Fair Labor Standards Act,[87] and the Occupational Safety and Health Act of 1970,[88] even though cooperatives may not be mentioned in these statutes.

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[78]43 U.S.C. 485h(c). See also 43 U.S.C. 522.

[79]16 U.S.C. 833c.

[80]16 U.S.C. 590z(7).

[81]16 U.S.C. 836.

[82]16 U.S.C. 825s.

[83]7 U.S.C. 1421 and 15 U.S.C. 714j (price support and commodity loans); 7 U.S.C. 1921 *et seq.* (credit); 42 U.S.C. 1471 *et seq.* (housing); 42 U.S.C. 2841-55 (poverty in rural areas); Pub. L. 84-1018, 70 Stat. 1088 (watershed protection); Pub. L. 87-703, 76 Stat. 605 (rural renewal); Pub. L. 89-4, 79 Stat. 5 (timber development); Pub. L. 89-796, 80 Stat. 1478 (nonprofit recreational associations).

[84]15 U.S.C. 41.

[85]7 U.S.C. 499a.

[86]29 U.S.C. 151; *National Labor Relations Board* v. *Grower-Shipper Vegetable Association*, 122 F.2d 368 (9th Cir. 1941).

[87]29 U.S.C. 201; *Redlands Foothill Groves* v. *Jacobs*, 30 F. Supp. 995 (S.D. Calif. 1940).

[88]Pub. L. 91-596, 84 Stat. 1590.

OTHER PUBLICATIONS AVAILABLE

More detailed information on particular steps in the cooperative-forming process is in other publications of the Farmer Cooperative Service listed below. For copies, write Farmer Cooperative Service, U.S. Department of Agriculture, Washington, D. C. 20250.

Capper-Volstead Impact on Cooperative Structure. Joseph G. Knapp. 1975. Information 97. 42 pp.

Understanding Capper-Volstead. David Volkin. 1974. Reprint 392 from News for Farmer Cooperatives. 5 pp.

Improving Management of Farmer Cooperatives. Milton L. Manuel. Revised 1973. General Report 120. 47 pp.

A Financial Profile of Farmer Cooperatives in the United States. Nelda Griffin. 1972. FCS Research Report 23. 95 pp.

Managing Farmer Cooperatives. Kelsey B. Gardner. 1963. Educational Circular 17. 20 pp.

How the Adjustable Revolving Fund Capital Plan Works. Nelda Griffin. 1963. General Report 111. 8 pp.

What Are Patronage Refunds? Kelsey B. Gardner. 1963. Information 34. 15 pp.

Handling Net Margins Under the New Tax Law. Raymond J. Mischler. 1963. Information 39. 12 pp.

U.S. GOVERNMENT PRINTING OFFICE : 1976 O—205-495

FARMER COOPERATIVE SERVICE
U.S. DEPARTMENT OF AGRICULTURE

Farmer Cooperative Service provides research, managment, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

The Service (l) helps farmers and other rural residents obtain supplies and services at lower cost and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs.

The Service publishes research and educational materials and issues *Farmer Cooperatives*. All programs and activities are conducted on a nondiscriminatory basis, without regard to race, creed, color, sex, or national origin.